

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission)	
on its own motion)	Docket No. 01-0705
)	
Northern Illinois Gas Company d/b/a NICOR)	
Gas Company)	
)	
Reconciliation of Revenues collected under)	
Gas Adjustment Charges with Actual Costs)	
prudently incurred)	
)	
Illinois Commerce Commission)	
on its own motion)	Docket No. 02-0067
)	
Northern Illinois Gas Company d/b/a NICOR)	
Gas Company)	
)	
Proceeding to review Rider 4, Gas Cost, pursuant)	
to Section 9-244(c) of the Public Utilities Act)	
)	
Illinois Commerce Commission)	
on its own motion)	Docket No. 02-0725
)	
Northern Illinois Gas Company d/b/a NICOR)	
Gas Company)	
)	
Reconciliation of Revenues collected under)	
Gas Adjustment Charges with Actual Costs)	
prudently incurred)	

DIRECT TESTIMONY ON REOPENING
OF
RICHARD J. ZURASKI

Senior Economist
Illinois Commerce Commission
Energy Division—Policy Section

November 21, 2003

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I. Witness Qualifications

Q. State your name and business address.

A. Richard J. Zuraski, Illinois Commerce Commission, 527 East Capitol Avenue,
Springfield, Illinois, 62701.

Q. By whom are you employed and in what capacity?

A. I am employed as a Senior Economist in the Illinois Commerce Commission's
Energy Division—Policy Program.

Q. What are your responsibilities within the Energy Division—Policy Program?

A. I provide economic analyses and advise the Commission and other staff members
on issues involving the gas and electric utility industries. I review tariff filings and make
recommendations to the Commission concerning those filings. I provide testimony in
Commission proceedings. In selected cases, I sometimes act as an assistant to
Commissioners or to administrative law judges.

Q. State your educational background.

A. I graduated from the University of Maryland with a Bachelor of Arts degree in
Economics. I obtained a Masters of Arts degree in Economics from Washington
University in St. Louis. I completed other work toward a doctorate in economics from
Washington University, but did not complete all requirements for that degree.

Q. Describe your professional experience.

A. Since December 1997, I have been a Senior Economist in the Policy Program of
the Commission's Energy Division. I held the same position from February 1990 to

December 1997, in the Commission's Office of Policy and Planning (prior to its incorporation into the Energy Division). Before that, I held positions in the Commission's Least-Cost Planning Program and Conservation Program. While employed by the Commission, I have testified in numerous docketed proceedings before the Commission. Prior to coming to the Commission in November 1987, I was a graduate student at Washington University, where I taught various courses in economics to undergraduate students in the Washington University night school and summer school.

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the staff of the Illinois Commerce Commission ("Staff").

II. Purpose of Testimony and Background Information

Q. What is the subject matter of your testimony on reopening?

A. This testimony concerns Staff's investigation, since July 2002, of Nicor Gas Company ("Nicor Gas" or "the Company"), the costs included in the Company's purchased gas adjustment clause ("PGA") in 1999 through 2002, and the Company's Gas Cost Performance Program ("GCPP" or "Program"), which was in effect in 2000, 2001, and 2002. This investigation started following the revelation by CUB of a fourteen-page fax ("the whistle-blower fax"). The fax had been sent to CUB on June 21, 2002 by an anonymous source who accused Nicor of certain perceived improprieties surrounding the GCPP. I will also be responding to portions of the direct testimony on reopening of Nicor witnesses D'Alessandro, Lassar, Feingold, Barrett, and Moretti.

The GCPP was approved by the Commission at the end of November 1999, in its Docket 99-0127 Order, and went into effect on January 1, 2000. Two years later, the Commission initiated Docket 02-0067, pursuant to Section 9-244 (c), to determine whether the GCPP was meeting its objectives and to identify any revisions necessary to result in the program meeting its objectives. Testimony was filed and the record marked heard and taken. After the existence of the whistle-blower fax was brought to the Commission's attention, eventually Docket 02-0067 was reopened and consolidated with the PGA reconciliation dockets 01-0705 (2001) and 02-0067 (2002). Since the Company and Staff have both identified adjustments to the 1999 and 2000 PGAs, arising from this investigation, the 1999 and 2000 PGA reconciliation dockets should also be reopened.

Q. Please provide an overview of the GCPP.

A. The GCPP is a performance-based regulation ("PBR") program in which the Company shares in gas cost "savings" (whether they are negative or positive). Savings are defined as the difference between a multi-part benchmark (which I will describe in the next question and answer) and the actual gas costs that are accounted for using the standard PGA. The computation of savings takes place at the end of the calendar year and the Company's share of savings is added into (for positive savings) or subtracted from (for negative savings) the following year's rates. The Company's share is 50 percent.

Q. Please provide an overview of the multi-part benchmark used in this Program.

A. The GCPP's benchmark gas cost is: a "Market Index Cost" - a "Storage Credit Adjustment" + a "Firm Deliverability Adjustment" + a "Commodity Adjustment."

65 The Market Index Cost (“MIC”) is a weighted average of a monthly price index
66 where the weights are the actual quantities delivered to customers during each month of
67 the year. The monthly price index is itself an average of several different daily and first-
68 of-the-month published price indexes.

69 The Storage Credit Adjustment (“SCA”) represents the difference in the value of
70 gas when it was withdrawn from storage and the value of gas when it was injected into
71 storage. This difference fluctuates from year to year simply due to the movement in
72 market prices. The SCA, for any given year, equals a weighted average price differential
73 times the actual annual withdrawals from storage (The weights were fixed in Docket 99-
74 0127.).

75 The Firm Deliverability Adjustment (“FDA”) represents various costs accounted
76 for within the purchased gas adjustment clause that are more dependent upon forecasted
77 maximum demand levels than actual demand levels. In Docket 99-0127, the Commission
78 set the level of the “FDA” at a lump sum of \$116,582,612 per year (where it remained
79 throughout the life of the program).

80 The Commodity Adjustment (“CA”) is basically a catch-all or residual
81 adjustment. In Docket 99-0127, a CA rate was set to a level of 1.68 cents per MMBTU,
82 which, on average, over several historical years, would have equated the total benchmark
83 gas costs with the Company’s actual historical gas costs. That is, the average savings
84 would have been zero. During each of the three years that the Program was in existence,
85 the CA has been 1.68 cents per MMBtu times the actual number of MMBtu delivered to
86 customers during the year.

87 **Q. From an arithmetical perspective, how will you compute the refunds or surcharges**

that arise from this review of the PBR program?

A. As noted above, during the life of the PBR program, the difference between the benchmark and the Company's actual gas costs was defined as "savings." Savings were shared between the Company and ratepayers according to a 50-50 sharing rule. If the benchmark went up (down) by a dollar or if gas costs went down (up) by a dollar, then savings would also go up (down) by a dollar, and the Company would recover (or refund to customers) an incremental (or decremental) 50 cents in the next year.

In this testimony, as errors committed during the 2000-2002 period are identified, I will show how the correction affects both gas costs and savings at the same time.

Hence:

- A decrease of a dollar in *either* gas costs or the benchmark should lead to a refund of 50 cents, while an increase of a dollar in *either* gas costs or the benchmark should lead to a surcharge of 50 cents.
- A one dollar increase (decrease) in *both* gas costs and the benchmark should lead to a surcharge (refund) of one dollar.
- Finally, if costs and benchmark were to change in *equal but opposite* directions, then there should be neither refund nor surcharge.

For instance, in the last bulleted case, suppose costs were originally a dollar too low and the benchmark was originally a dollar too high. If gas costs should have been a dollar higher, then we now have to allow the Company to collect an additional dollar in costs. However, if at the same time the benchmark should have been a dollar lower, then we also find that corrected savings are two dollars lower than originally computed; with the 50-50 sharing rule, ratepayers originally paid a dollar too much in savings. Hence, in correcting the previous errors, the one dollar gas cost surcharge offsets the one dollar

refund owed to customers for the original excessive PBR contributions. In case this is not very intuitive, the following table summarizes the above-described arithmetic process, using six simplified examples.

Table 1. Arithmetic Mechanics of Correcting Costs and the PBR Benchmark

	Original	Cost Increase	Benchmark Increase	Cost Decrease	Benchmark Decrease	Equal Change	Equal but Opposite Change
Costs	100.00	101.00	100.00	99.00	100.00	101.00	101.00
Benchmark	120.00	120.00	121.00	120.00	119.00	121.00	119.00
Savings	20.00	19.00	21.00	21.00	19.00	20.00	18.00
Change in Costs		1.00	-	(1.00)	-	1.00	1.00
Change in Benchmark		-	1.00	-	(1.00)	1.00	(1.00)
Change in Savings		(1.00)	1.00	1.00	(1.00)	-	(2.00)
Refund (Surcharge) due to Cost recalc.		(1.00)	-	1.00	-	(1.00)	(1.00)
Refund (Surcharge) due to Savings recalc.		0.50	(0.50)	(0.50)	0.50	-	1.00
Net Refund (Surcharge)		(0.50)	(0.50)	0.50	0.50	(1.00)	-
An increase in the benchmark leads to the same surcharge as an increase in costs (50% of the increase). A decrease in the benchmark leads to the same refund as a decrease in costs (50% of the decrease).							

In addition, changes to gas costs and PBR savings in 1999 through 2002 change the reconciliation imbalances upon which interest owed to either the Company or customers should be computed.

III. Summary of Conclusions and Recommendations

Q. Please summarize your conclusions and recommendations?

A. According to Nicor witness D'Alessandro, "Nicor is seeking a determination from the Commission that the GCPP met its goals, provided substantial benefits to customers, and, after making certain adjustments for accounting errors, a finding that Nicor has under-collected \$6,991,014 from customers. Given this under-collection, Nicor seeks to recover this sum through its existing Rider 6." (D'Alessandro Direct, p.7) While Staff will address each of these issues, the most important of them is the degree to which Nicor has over or under-collected from ratepayers. Along these lines, my conclusions and recommendations can be summarized as follows:

130 **A)** From the start of Docket 99-0127, through June of 2002 in Docket 02-0067, the
131 Company withheld crucial information concerning plans to tap into low cost LIFO
132 layers in storage inventory. In essence, the Company discovered a way to profit with
133 virtually no effort by withdrawing old gas (purchased well before the PBR program
134 went into effect) that originally cost the Company less than 40 cents per MMBTU.
135 Under the PBR program, this old 40 cent gas would be compared to a contemporary
136 market price index that ranged between \$2 and \$10 per MMBTU. Under such
137 circumstances, creating “savings” was never easier. Adjustments correcting for
138 certain improper accounting of a 1999 sale to a firm called IMD of NGPL storage gas
139 (see B, below) and for “prefill” deals (see C, below) has a significant effect on the
140 size of the net withdrawals during the PBR program (in fact, eliminating them for
141 2001). However, in 2000 and 2002, even after those accounting corrections, there are
142 still some net withdrawals of the old inexpensive gas. Staff recommends that the
143 Commission modify the share-the-savings formula for 2000 and 2002 to eliminate the
144 Company’s share of savings due specifically to the difference between the market
145 cost of gas and the revised inventory price of the revised net withdrawals from
146 storage. The effect of this adjustment is a refund to customers of about \$20.8 million
147 (that is, one-half the post-restatement LIFO-derived savings of about \$41.7 million).
148 This is an adjustment not included in the Company’s reopening testimony.

149 **B)** To initiate its plan to profit from the embedded cost of old gas in storage
150 inventory, the Company made a significant withdrawal from storage in December
151 1999 (just before the start of the PBR program), as part of a deal with a firm called
152 IMD. This helped Nicor to effectively purge storage inventory of its two high-priced

gas layers, reflecting the most recent net injections that occurred in 1996 and 1984.¹ The sale to IMD in December 1999 was done at then-current market prices, at a loss relative to the embedded cost of these higher-priced inventory layers. This loss was born entirely by ratepayers as part of the 1999 PGA. While the Company's accounting restatement partially addresses the issue of the December 1999 sale, I do not believe it fully recognizes the entire burden placed on ratepayers due to this sale. Thus, Staff recommends that the Commission order an additional cost disallowance of about \$2.7 million for 2000, based on the increase in 2000 gas costs that arose out of this transaction. Given the 50-50 sharing formula, the effect of this cost disallowance is a refund to ratepayers of about \$1.35 million, which is an amount not included in the Company's reopening testimony.

C) After the Company removed all the high-priced LIFO layers from inventory via the December 1999 sale to IMD, the remaining inventory was all priced well-below current market prices. Documents provided to Staff show that the Company was clearly relying on its ability to make substantial net withdrawals in 2000 and beyond, facilitated by some questionable accounting of "prefill" deals. Through the PBR program, the Company would share half the "savings" derived from flowing the extremely low-priced gas left in inventory after the 1999 depletion through the 2000 and beyond PGAs. As explained by Staff's accounting expert testifying in this proceeding, the Company inappropriately accounted for so-called "prefill" deals in 2000 through 2002. At least one of the main purposes of the prefill deals and prefill accounting was apparently to gain greater control over annual net withdrawals from

¹ All other years between 1973 and 1999 were net withdrawal years and thus created no new inventory layers.

storage inventory. More specifically, the prefill accounting was used as a tool to gain access to the relatively old and low-priced LIFO inventory layers. The prefill deals were also structured in such a manner that the Company was able to double-collect for a portion of its carrying charges. Staff recommends that any improper accounting be reversed and any carrying charges associated with the prefill deals be removed from the PGA. It is my understanding that the Company has made the accounting corrections in its re-opening restatement. Notably, the proposed accounting corrections actually increase gas costs that were originally reported for 2000 and 2001, but also have the effect of leaving more low-cost gas in storage inventory (providing a lower rate base during the Company's next rate case, or providing a larger reservoir of this low-priced gas for future PGA years). The effect of denying the carrying charges is largely undetermined at this time because the Company has not yet paid for all of the prefill gas and, in Staff's view, carrying charges continue to accrue. The Company's accounting changes actually deduct a significant portion of the "direct" carrying charges incurred during the life of the PBR program. However, the Company has not made any adjustments for "indirect" carrying charges, which Staff computes to be approximately \$604,980 for 2001 and \$2,437,060 for 2002. Given the 50-50 sharing formula, excluding these indirect carrying charges from the PGA would lead to additional refunds of \$302,490 and \$1,218,530, in 2001 and 2002, respectively. These are additional refunds not included in the Company's reopening testimony.

D) The 2000 and 2001 GCPP benchmark (specifically, the storage credit component of the benchmark approved by the Commission) was improperly and inaccurately

computed by the Company, leading to substantial errors in the computation of “savings” under the Program. In particular, the Company improperly subtracted “infield transfers” from gas withdrawals. In addition, except when it added back “virtual storage,” the Company improperly ignored storage withdrawals by IMD (the firm to which Nicor Gas released substantial quantities of storage capacity just prior to the beginning of the program). Furthermore, the Company failed to inform the Staff about these matters until some time after July 2002. These errors generally raised the benchmark and thus inflated the computation of “savings.” The Company now proposes several changes in the benchmark that only partially address Staff’s concerns. Over the three years of the PBR program, the Company’s originally-computed storage credit component of the benchmark led to a combined credit (2000 through 2002) of about \$2 million. In contrast, the Company’s re-opening restatement of the benchmark leads to a combined storage credit of about \$34 million. However, the Staff’s computations lead to a combined storage credit of about \$84 million. Given the 50-50 sharing formula, the effect of Staff’s adjustment is a net refund of about \$41 million (one-half of \$84 minus \$2 million). Compared to the Company’s reopening testimony, this amounts to an additional refund of about \$25 million (one-half of \$85 million minus \$34 million).

E) Nicor Gas took actions that knowingly led to an increase in the cost of gas included in the PGA by engaging in at least one transaction with an affiliate (NICOR Enerchange) in which Nicor Gas sold gas to Nicor Enerchange for future delivery at a price demonstrably less than the spot price of gas at the time of the transaction, the prevailing prices of futures contracts for the delivery months, and the eventual spot

prices prevailing at the time of actual delivery. Staff recommends that the excess costs incurred as a result of this transaction be subtracted from allowable PGA gas costs. This leads to a refund to customers of \$4,258,586 (half the excess costs incurred as a result of this transaction). This is an adjustment not included in the Company's reopening testimony.

F) The Company took actions that knowingly led to an increase in the cost of gas included in the PGA by engaging in at least one transaction where Nicor Gas received a discount on a non-PGA purchase of weather insurance in exchange for providing the vendor (Aquila) with a discount on a sale of gas. Staff recommends that the estimated increase in gas costs that resulted from this transaction be removed from gas costs. This removal leads to a refund of about \$3 million (half the estimated increase in gas costs). The Company makes an adjustment associated with the Aquila transaction, but computes it to be only \$1 million, so Staff's adjustment amounts to an additional refund of about \$2 million not included in the Company's reopening testimony.

G) The Company structured several deals--involving the release of NGPL purchased storage--that shifted the burden of carrying charges from the Company's base rate accounts to the PGA accounts. This shift resulted in the Company recovering carrying costs both in its existing base rates and in the PGA. Staff recommends the reversal of the previous inclusion of these carrying charges in the PGA. This reversal leads to a refund of \$6,983,659 (half the estimated carrying charges removed from the PGA). This adjustment is not included in the Company's reopening testimony, and is also in addition to the Staff's carrying charge adjustments discussed under C, above.

- 244 **H)** The Company made an error in the reporting of 2001 deliveries of PGA gas to
245 customers. This error increased the benchmark and thus inflated the computation of
246 2001 “savings” by approximately \$2 million, leading to an overpayment by
247 ratepayers of one-half this figure. Staff recommends that ratepayers receive a refund
248 for the 2001 overpayment to the Company. The Company’s re-opening restatement
249 of the 2001 benchmark adequately addresses this concern and results in a refund of
250 \$1,160,484, which the Staff accepts.
- 251 **I)** The Company erred by excluding certain Nicor Hub services revenues from the
252 PGA. Correcting for this leads to a cost reduction adjustment of approximately \$10.3
253 million between the beginning of 1999 and the end of 2002, with about \$1.9 million
254 of that total applicable to 1999, and the remaining \$8.4 of that total applicable to the
255 PBR period 2000-2002. After taking into account the effect of the PBR’s 50-50
256 sharing mechanism, the refund due to ratepayers would be \$6.1 million (i.e., $0.5 \times$
257 \$8.4 million + \$1.9 million).
- 258 **J)** As noted earlier, the Company made several accounting adjustments, which had
259 effects on both the storage credit adjustment component of the benchmark and on
260 costs. The changes with respect to the storage credit adjustment component of the
261 benchmark have already been discussed (see item D, above). The accounting
262 restatement’s more direct effect on gas costs was approximately a \$15 million
263 increase, due primarily to less of the low-cost LIFO layer gas being withdrawn from
264 storage. Staff is not disputing this restatement.

265 **K)** According to Staff witness Maple, there should be additional refunds of
266 \$8,915,055 due to adjustments to the benchmark in 2000 through 2002, as well as to
267 gas costs in 1999.

268 **L)** According to Staff witness Knepler, there should be additional refunds associated
269 with lost storage gas, the cost of which the Company has been including in the PGA.
270 The Company has been accounting for lost gas by adding two percent to all actual
271 withdrawals from storage. After transportation customers pay for their share of lost
272 storage gas, the Company has been recovering the remaining cost through the PGA.
273 However, according to Mr. Knepler, the Commission's PGA rule does not permit
274 utilities to recover the cost of lost storage gas through the PGA. Rather, the expense
275 of lost storage gas is a legitimate base-rate item. In consultation with Mr. Knepler, I
276 have computed the quantity of the lost gas recovered through the PGA in 1999
277 through 2002 by taking 2% of aquifer withdrawals and subtracting 2% of withdrawals
278 by transportation customers. In net withdrawal years (1999, 2000, and 2002), I
279 valued the lost gas at the original cost of the withdrawn storage inventory, using the
280 LIFO convention. In the net injection year (2001), I valued the lost gas at the original
281 cost of the new 2001 LIFO layer, as computed by the Company. Removing from the
282 PGA the computed cost of lost storage gas leads to an additional refund of
283 \$25,983,326 . This constitutes 100% of the computed cost of the lost gas in 1999, as
284 well as 100% of the computed cost of the lost gas in the 2000 to 2002 period when
285 the PBR program was in effect. In other words, I did not permit this adjustment to
286 increase "savings" in 2000 through 2002, under the theory that the benchmark should
287 also have excluded these costs.

To summarize, all the above adjustments amount to a subtotal of \$106.6 million to be refunded to customers. After netting off the Company's originally-computed 2002 PBR savings share of \$26.9 million² and a \$1.3 million undercharge from originally booked 2001 savings, and adding Staff-computed carrying charges owed to ratepayers of \$4.5 million, the net refund to customers amounts to about \$82.8 million. Finally, after including a Company-computed \$18.8 million "PGA Adjustment to reflect 2002 Final Gas Costs," (see TMM-2, pp. 7-8), the final refund to customers is \$101.6 million. When compared to the \$7 million surcharge requested in the Company's reopening testimony, Staff's adjustment is \$108.6 million more favorable to ratepayers.

The following table (Table 2 below) compares, by issue, Staff's proposed refunds and surcharges to the Company's proposed refunds and surcharges. A more detailed version of this table (by issue and by year) is included in **Attachment 1**.

² The Company did not seek to recover its share of the originally-computed 2002 savings during 2003, so the amount remains uncollected, to date.

300

Table 2. Summary of Refunds, by Issue

Item	Recommendation	Amount of Refund (Surcharge) per Staff	Amount of Refund (Surcharge) per Company	Additional Refund (Surcharge) per Staff
A	Refund of 1/2 LIFO-related Savings	\$20,844,715	\$0	\$20,844,715
B	Refund for added costs associated with the improper timing of Dec 99 IMD transaction not already included in item J	\$1,350,000	\$0	\$1,350,000
C	Refund for Imputed (non-explicit) Carrying Charges Associated with Prefills not already included in item J	\$1,521,020	\$0	\$1,521,020
D	Refund for changes in SCA:	\$41,417,454	\$16,100,039	\$25,317,416
d1	o Accounting Corrections	\$8,040,338	\$8,040,338	\$0
d2	o Virtual Inventory	\$4,609,701	\$4,609,701	\$0
d3	o Other Bchmrk Withdrawals	\$14,167,514	\$0	\$14,167,514
d4	o In-field Transfers	\$14,599,901	\$3,450,000	\$11,149,901
E	Refund for Affiliate Discount	\$4,258,586	\$0	\$4,258,586
F	Refund for Gas Sale Discount that was tied to a Weather Insurance Discount	\$3,057,525	\$1,000,000	\$2,057,525
G	Refund for Released NGPL Storage Carrying Charges	\$6,983,623	\$0	\$6,983,623
H	Refund for Meter Error	\$1,160,484	\$1,160,484	\$0
I	Refund for Improper Exclusion of Certain Hub Revenues	\$6,150,917	\$0	\$6,150,917
J	Surcharge for Company proposed Accounting Corrections to gas costs (not to benchmark, which are included in d1)	(\$15,059,454)	(\$15,059,454)	\$0
K	Total Refunds due to Maple Adjustments	\$8,915,055	\$0	\$8,915,055
k1	o Maple Adjustment 1	\$1,475,267		\$1,475,267
k2	o Maple Adjustment 2	\$5,893,472		\$5,893,472
k3	o Maple Adjustment 3	\$1,546,317		\$1,546,317
L	Staff Accounting Adjustment Removing 2% of WD	\$25,983,326	\$0	\$25,983,326
	SUBTOTAL1	\$106,583,251	\$3,201,068	\$103,382,183
+	Surcharge for 1/2 Original 2002 Savings (so-far uncollected)	(\$26,875,870)	(\$26,875,870)	\$0
+	Undercharge from originally booked 2001 savings (see TMM-3)	(\$1,329,699)	(\$1,329,699)	\$0
+	Interest owed to Customers (Company)	\$4,450,799	(\$780,374)	\$5,231,173
=	SUBTOTAL2	\$82,828,482	(\$25,784,874)	\$108,613,356
+	PGA Adj to reflect 2002 Final Gas Costs (TMM-2 , pp. 7-8)	\$18,793,860	\$18,793,860	\$0
=	TOTAL	\$101,622,342	(\$6,991,014)	\$108,613,356

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The following table (Table 3) shows, by year, how Staff's adjustments alter the Company's computation of savings. More detailed tables, showing Staff's adjustments to PBR savings in a form more comparable to Company Exhibits MEB-3, MEB-4, and MEB-5, can be found in my **Attachment 2**.

Table 3. Staff Proposed Changes to PBR Savings by Year

Year	Change in PGA	Change in Benchmark	Original Savings	Revised Savings	Change in Savings	Original Savings Attributable to Storage Decrement from LIFO layers	Revised Savings Attributable to Storage Decrement from LIFO layers	Change in Savings Attributable to Storage Decrement
1999	(\$24,445,418)	0.00	0.00	0.00	0.00	(\$22,058,472)	(\$8,331,615)	\$13,726,857
2000	\$13,357,526	\$11,347,572	\$24,435,279	\$16,539,857	(\$7,895,422)	\$26,719,391	\$22,031,074	(\$4,688,317)
2001	\$1,649,442	(\$113,070,729)	\$29,702,858	(\$90,103,000)	(\$119,805,858)	\$26,384,520	\$1,662,461	(\$24,722,060)
2002	(\$17,645,266)	\$1,829,806	\$53,751,739	\$64,143,380	\$10,391,640	\$29,888,392	\$19,658,357	(\$10,230,036)
Total	(\$27,083,716)	(\$99,893,351)	\$107,889,877	(\$9,419,763)	(\$117,309,640)	\$60,933,832	\$35,020,276	(\$25,913,556)

Note: For 1999, the “savings attributable to storage decrement from LIFO layers” affect the PGA but do not affect the PBR or the sharing of PBR savings. For 2001, after the accounting restatement, there was a storage increment rather than a decrement; thus, Staff does not attempt to remove anything from the Company’s share of savings in 2001 for “savings attributable to storage decrement from LIFO layers.”

Finally, Table 4 shows, by year, the refunds to customers after Staff’s adjustments

are taken into account.

Table 4. Staff Proposed Refunds by Year

	1/2 of Original 2002 Savings	Change in PGA Costs	1/2 Change in Savings and 1/2 of LIFO Savings from Previous Year	Undercharge from originally booked 2001 savings (see TMM-3)	PGA Adj to reflect 2002 Final Gas Costs (TMM-2, pp. 7-8)	Subtotal	Factor O Interest	Total
1999		(\$24,445,418)				(\$24,445,418)		(\$24,445,418)
2000		\$13,357,526				\$13,357,526	(\$1,344,498)	\$12,013,028
2001		\$1,649,442	(\$14,963,248)			(\$13,313,806)	(\$745,943)	(\$14,059,750)
2002		(\$17,645,266)	(\$59,902,929)	\$1,329,699	(\$18,793,860)	(\$95,012,356)	(\$529,843)	(\$95,542,199)
2003	\$26,875,870		(\$4,633,358)			\$22,242,512	(\$1,830,515)	\$20,411,996
Total	\$26,875,870	(\$27,083,716)	(\$79,499,535)	\$1,329,699	(\$18,793,860)	(\$97,171,543)	(\$4,450,799)	(\$101,622,342)

IV. Corrections and Adjustments to Storage Inventory, Gas Costs, and the PBR Benchmark

A. Eliminating the Company’s Share of Savings Due to Net Withdrawals of Low-Priced Old LIFO Layer Gas

1. Basic Explanation of the LIFO Savings Issue

Q. What crucial information did Nicor Gas withhold concerning gas in storage inventory?

A. The information that the Company withheld was that Nicor had a plan for generating easy no-risk savings by tapping into low-cost LIFO layers of its storage inventory.

Q. What was the plan for generating easy no-risk savings by tapping into low-cost LIFO layers of its storage inventory?

A. At the end of 1998, just before the Company made its PBR filing, there was a significant range in the per unit gas costs of its gas in storage. Table 5 shows the years in which annual injections exceeded annual withdrawals, the per unit cost of gas associated with each of these “LIFO layers,” and the number of therms in each layer.

Table 5. LIFO Layers

Relevant Inventory Details as of 12/31/1998		
Year of net injection	\$/Therm	Net Injections Therms
2/1/54	0.01881784	350,145
2/1/54 - 12/31/54	0.02141938	6,801
1955	0.02388499	29,967
1956	0.02391411	24,171
1959	0.02564789	477,564
1960	0.0287233	530,700
1961	0.02957997	27,198
1962	0.02857367	38,230
1963	0.02936081	12,315,551
1964	0.02895129	27,585,092
1965	0.02883622	63,629,015
1966	0.02802164	28,141,967
1967	0.02818208	3,543,990
1968	0.02628143	165,383,411
1969	0.02880890	71,993,124
1970	0.03101795	282,791,456
1971	0.03638312	52,837,489
1973	0.04541432	35,397,594
1984	0.32314892	166,310,843
1996	0.28756513	101,399,732

A net injection in any given year creates a new inventory layer, based on the average cost of purchases in that year. Conversely, a net withdrawal (not shown in the table above) results in an inventory reduction, on a last-in first-out (LIFO) basis. Thus,

the most recent layers are depleted first. The table shows, as the 1999 gas year was beginning, there was a significant difference between the price of gas in the last two layers (1996 and 1984) and all the layers created prior to 1984.

Since July 2002, it has become clear to Staff that the Company placed great significance on the opportunity presented by PBR to tap into the difference between current market prices (reflected in the PBR benchmark) and the extremely low prices that were embedded in the Company's pre-1984 storage inventory layers.³ The Company was clearly developing the strategy as early as October 1998, when a so-called "Inventory Value Team" issued a report to upper management at Nicor focusing on this opportunity.⁴ About four months later, on March 1, 1999, the Company filed its petition to initiate the PBR program.

To enable shareholders to profit from the difference between current market prices and the pre-1984 storage inventory prices, the Company first had to find a way to brush aside the last two relatively high-priced LIFO layers (i.e., the 1984 and 1996 layers). It assured this in December 1999 (just days before the PBR went into effect) by transferring a large quantity of gas (and capacity) from an NGPL storage account to a

[illegible]

4 The Inventory Value Team Report was provided to Staff as NIC 003655-003671, in response to a data request. The first page in the body of the report states, in part, “The ‘top’ 30% of our LIFO layers are priced at close to market value. The ‘bottom’ 70% of our LIFO layers are priced significantly below market value. There is about 75 BCF of gas in these lower priced layers, with market value of about \$100-200 million in excess of cost. ... We recommend that the Company ‘capture’ the LIFO inventory value by filing and implementing a Gas Rate Performance Plan (GRPP) related to gas costs.” (NIC 003657)

firm called IMD. This is discussed in the next section. Once that was accomplished, though, the Company would be able to show PBR “savings” in 2000 and beyond by engaging in so-called “pre-fill” deals. These pre-fill deals allowed Nicor to maintain normal physical storage operations while still showing extraordinary net withdrawals from an accounting standpoint. The “pre-fill” accounting is discussed in the section following the next.

Whether Nicor planned all along to generate substantial savings from the low-cost LIFO layers or to simply use them as insurance against other risks, Nicor did in fact end up relying heavily on the LIFO strategy. For 2000 and 2001, prior to the Company's re-opening accounting restatement, the "savings" attributable to the LIFO strategy were approximately \$53 million, half of which would be retained by the Company.⁵ And yet, prior to July 2002, the Company never revealed the LIFO strategy to Staff. In fact, internal memoranda reveal that the Company was keen to keep this information from the Staff, and was worried that the Staff might figure out the LIFO strategy on its own.⁶

⁵ In comparison to the \$53 million in LIFO strategy savings, the total savings over the first two years was about \$54 million; so all other strategies combined produced net savings of only \$1 million.

[illegible]

Overall, the strategy seems to have been the Company's proverbial ace-in-the-hole. Indeed, examination of the Company's so-called "Buckets Reports" (which the Company began creating by the first quarter of 2001 but were provided to Staff only after the whistle-blower fax was sent), reveal how the Company would first project its PBR performance without any LIFO decrement, under both best-case and worst-case scenarios, and Nicor would then compute the amount of LIFO inventory it would need to withdraw in order to reach a pre-determined PBR savings goal. For example, in May/June of 2001, a Buckets Report projected 2001 annual PBR performance without the LIFO inventory decrement to range between a worst-case of xxxxxxxxxxxxxxxxxxxx

[illegible]

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384 X X XX XXXXXXXX.⁷

385 **Q. Were there any long-run implications of the LIFO layer depletion strategy?**

386 A. Presumably, once the PBR program ended, the Company would eventually refill
387 the inventory at contemporary market prices, creating a whole new set of 21st century
388 LIFO layers.⁸ At the Company's next rate case, the Company would attempt to include
389 the higher-priced inventory in rate base and attempt to recover the resulting higher
390 revenue requirements through base rates. Furthermore, at some point, future net
391 withdrawals from storage would include the higher-priced gas in the new 21st century
392 LIFO layers, and ratepayers would pay 100% of the cost of those higher-priced layers in
393 such years. Hence, the LIFO strategy did not so much reduce gas costs as move them
394 around temporally (lowering PGA costs during the life of the PBR program and most
395 likely increasing base rates and PGA rates at a later date).

396 **Q. Should the GCPP have been modified to account for the LIFO strategy?**

397 A. Yes. There is no question that the PBR mechanism as proposed by the Company
398 (and largely adopted by the Commission), was completely blind to the Company's

⁷ KPMG 024442. For other examples, see footnote 42.

⁸ A presumption substantiated by XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

ultimate plan and completely incapable of fairly allocating the value of gas in storage inventory. It is important to understand that the LIFO strategy was an accounting trick to take advantage of historical differences in market prices and not an actual change in the physical operation of storage. The LIFO strategy did not reflect any improvements in efficiency or gas purchasing acumen. Hence, gas volumes and costs associated with net storage injections and withdrawals should have been somehow excluded from the PBR savings calculation.

2. Comments on the Company's Position

Q. How does the Company attempt to justify its 50% retention of the LIFO savings?

A. The Company has taken the position that Nicor's stored gas is owned by Nicor and that Nicor is thus entitled to all profit derived from the liquidation of that asset (see, for example, Feingold, p. 35; Barrett, pp. 27-31). I suppose that an unstated corollary to this proposition is that the Company was munificently sharing half of that profit with ratepayers during the tenure of the PBR program.

Q. Do you agree with the Company's justification?

A. No. First, I do not dispute that the gas in inventory is the property of Nicor until it is sold to ratepayers. However, this is true not just for stored gas, but for flowing gas, as well. The fact that somebody has to own the gas before it is sold does not justify customers paying too much for it. In this case, the price of the gas sold to ratepayers reflects not just the cost of the gas, but also a bonus payment to Nicor for supposedly superior performance relative to a reasonable benchmark. In the case of accessing the low-cost LIFO gas, though, Nicor's performance was more surreptitious than superior,

and the benchmark was more rigged than reasonable. That is, because the Commission was unaware of the easy LIFO savings opportunity, the benchmark was flawed and the performance of the Company in achieving “savings” was misjudged accordingly.

Second, prior to the 1999 PBR filing, Nicor seemed to be well aware that the Commission would ultimately recognize the weakness in the Company's rationalization for retaining all the profits from storage liquidation. Toward the end of 1998, this is what the Company's Inventory Value Team⁹ said about Nicor's investment in storage inventory:

Like land, top gas inventory is non-depreciable. Therefore, a possible means of capturing the below market value of the gas inventory could be a filing with the Commission which argues that any revenue gained from such a sale [of that inventory] should accrue to the benefit of the shareholders, not the ratepayers. In 1990, the Illinois Commerce Commission ruled that the revenue gained from Nicor Gas' land sales should not be amortized over a period of time for the purpose of preserving the effect of the sale (the revenue gain) for rate making purposes. The below-market valued base gas in inventory bears some, but not perfect resemblance to land.

This potential means of releasing and capturing inventory value was considered a low risk approach with little possibility of success. It is low risk since we would be making a request to the Commission for specific authorization. It would have a low probability of being successful since storage inventory value is a function of gas costs, which is governed by the GSC. (NIC 003662)

Hence, the Company's own Inventory Value Team suspected that the Commission would reject a direct attempt to keep all the profits from a liquidation of the Company's storage inventory, regardless of who owned it. The Team correctly recognized that, unlike purchases and sales of land, net injections and withdrawals of

⁹ The Inventory Value Team Report cover contains the names of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx
xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxxxxxxx

storage gas are governed by the GSC (the Company's PGA). For decades, the PGA, as an automatic cost pass-through mechanism, has isolated the Company from the risk of gas price fluctuations. In return for this protection, all the State has asked from the Company is to make prudent purchases (and the Company has never suffered a prudence disallowance). The protection against gas price fluctuations, afforded by the PGA, contrasts with the lack of protection in the case of land transactions, for which application of the Commission-approved accounting treatment in the 1990 Order, referenced above, places the Company at risk for losses in value. Unlike theoretical downward fluctuations in the price of land, the Company has not been subject to the risk of downward fluctuations in the price of gas held in storage. In the regulatory bargain described above, the Commission has permitted the Company to recover the costs of gas withdrawn from storage on a dollar-for-dollar basis. Indeed, examples of losses on net storage withdrawals being passed through the PGA are highlighted later in my testimony.¹⁰

Now, with its recently-articulated position on LIFO savings, the Company seeks a new one-sided regulatory bargain. When it feels a need for it, Nicor wants the State's protection against unfavorable market fluctuations; but when Nicor is presented with a low-risk slam-dunk opportunity, Nicor eschews the protection of the traditional PGA in exchange for all the profits (or at least half of them).

Q. In reference to gas in underground storage, Mr. Barrett states,

Inclusion in rate base means that Nicor Gas is given the opportunity to earn

¹⁰ See p. 37, "Effect of Previous Net Withdrawals from Storage Inventory on the Original Creation of the PBR Benchmark in Docket 99-0127"; and p. 39, "Sale to IMD in December 1999".

a rate of return on its investment in gas in underground storage but *not* a return of its investment. *Nicor Gas's customers do not pay for the cost of gas in underground storage.* (Barrett Direct, p. 28, emphasis added)

Do you agree with Mr. Barrett?

A. No. Both of Mr. Barrett's statements are factually incorrect to some extent.

Starting with his first statement, the inclusion of dollars in rate base does ***not*** alone imply that a utility will ***not*** receive a return of those dollars in rates (with apologies for my double negative). For example, a piece of machinery with a finite useful life, as well as the non-recoverable portion of base gas in inventory, contributes to the utility's depreciation expense, through which a return of the investment is embedded in rates. Mr. Barrett's first statement is at best only true for those assets that do not depreciate, such as land, and the recoverable portion of base gas and top gas in inventory. Even for this subset of cases, though, his statement is still misleading because, for such non-depreciating assets, there is no periodic cost of replacing them, except perhaps when they are sold. Thus, it does not make sense to include a return of the investment in rates.

Notwithstanding the above-described ratemaking treatment, the utility does have an opportunity to earn a return of its investment in a non-depreciating asset, if and when it ultimately sells the asset. In that instance, some asset sales might be governed by tariffs approved by a public utilities commission, while others might not. It is unlikely, for example, that a natural gas utility would be selling land to ratepayers at tarified rates; quite simply, public utilities commissions are not in the business of regulating the price of land sales. Instead, the revenues earned by the utility for a land sale would most likely depend on private negotiations between the utility and potential buyers. In contrast, it is very likely that a gas utility would be selling natural gas to ratepayers at tarified rates,

494 which brings me to Mr. Barrett's second factually-incorrect statement. In the specific
495 case of Nicor's natural gas in storage inventory, ratepayers do indeed provide the
496 Company with a return of that investment, if and when the utility sells them the gas. That
497 is, through the PGA, Nicor's customers "pay for the cost of gas in underground storage"
498 when it is removed from inventory.

499 Hopefully, the above discussion will help prevent any misunderstanding that Mr.
500 Barrett's testimony could have created concerning Nicor's ability to recover the cost of
501 assets, in general, and natural gas, in particular. To sum up, standard regulatory practice
502 does not deny adequate recovery of the cost of natural gas, even if, at some stage, it was
503 accounted for within Nicor's storage inventory.

504 **Q. Mr. Barrett opines that,**

505 **Nicor Gas is allowed to manage the gas in inventory as part of strategies**
506 **designed to reduce costs to its customers, including selling some gas in**
507 **inventory. (Barrett Direct, p. 31, lines 646-647)**

508 **Do you agree that Nicor Gas "is allowed to manage the gas in inventory as part of**
509 **strategies designed to reduce costs to its customers, including selling some gas in**
510 **inventory"?**

511 **A.** Yes, I agree. However, being allowed to manage gas in inventory as part of
512 strategies designed to reduce gas costs is not the issue. The issue is whether there is any
513 good reason to give the Company a share of the dramatic differences in the market value
514 and the inventory value of gas withdrawn from the older LIFO layers of storage. In my
515 opinion, there is no good reason to give the Company a share. In fact, there are several
516 reasons for denying the Company such a share:

First, as should become clearer in a later section of my testimony (see p. 42), the LIFO decrement strategy was little more than an accounting maneuver which exploited increases in wholesale gas prices over time; such price changes had nothing to do with superior performance by Nicor. Indeed, all of the low-cost LIFO layers were created prior to the phased deregulation of natural gas by the Natural Gas Policy Act of 1978. Hence, one could argue that retired Federal regulators are more responsible for these LIFO-derived “savings” than the Company.

Second, as explained above (see p. 21) the accounting maneuver did not only reduce the cost of gas flowing into the PGA during the life of the PBR program, it also guaranteed that the inventory would someday be replaced at contemporary market rates. Thus, in all likelihood, ratepayers will see an incremental increase in base rates further down the road, as these higher inventory costs are translated into a higher test year rate base. Other reasons for denying the Company a share of the LIFO-related “savings” are provided throughout this section.

Q. Mr. Feingold states,

Given the much higher gas prices at the time the GCPP was proposed, and the common knowledge of the Company’s low-cost LIFO layers, the inherent benefit of these LIFO layers to the Company and its customers should have been apparent to all interested parties. (Feingold Direct, p. 37)

Mr. Barrett offers a similar opinion (Barrett Direct, p. 31). Was the “inherent benefit” of the LIFO layers apparent to all interested parties in Docket 99-0127?

A. No, it sure wasn’t. There is nothing in the record of 99-0127 to suggest that any party knew of the Company’s plans to exploit the low-cost LIFO layers. While some Staff members were aware of the existence of low-cost LIFO layers, to my knowledge

541 and belief, no Staff member was aware that there was a way for the Company to
542 effectively tap into those layers. Basically, the LIFO layers were seen by Staff as
543 relatively static (changing gradually) and pertinent only to such rate case issues as
544 calculating rate base. In 1999, from Staff's perspective, the inventory would have had no
545 material implications for the PBR program. As even Mr. Feingold's testimony implies,
546 there was no reason for the Staff to suspect that the old LIFO layers would bubble to the
547 surface,¹¹ let alone gale forth from inventory under the arguably-contrived influence of
548 "prefill" accounting.

549 In short, the near omniscience alleged by Feingold and Barrett is simply not in
550 evidence. Purportedly, even the Company was unaware of the LIFO opportunity until
551 1998, [REDACTED] XX.¹²
552 [REDACTED] the Inventory Value Team that outlined the strategy for
553 tapping into LIFO. Just two years earlier, around the time that the Company filed its first
554 PBR proposal (Docket 96-0386), the Company seems to have been just as oblivious to
555 the LIFO opportunity as was the Staff and other parties.¹³

556 Furthermore, as discussed later in my testimony (see p. 37, "Effect of Previous
557 Net Withdrawals from Storage Inventory on the Original Creation of the PBR
558 Benchmark in Docket 99-0127"), in the five years prior to the PBR going into effect, net
559 withdrawals from inventory involved LIFO layers that were fairly close to contemporary
560 market prices. In fact, the LIFO layer prices were slightly above market prices, so net

¹¹ Feingold Direct, p. 38 (lines 849-858)

¹² [REDACTED].

¹³ [REDACTED].

561 withdrawals actually increased the net costs that flowed through the PGA in those years.
562 Therefore, had they been even thinking of storage inventory as a potential factor in the
563 PBR program, interested parties would have more easily concluded that the storage
564 inventory would work against the Company during the life of the PBR.

565 Finally, in Docket 99-0127, the true significance of storage was further obscured
566 by the Company's assurances that Nicor would not and could not manipulate storage
567 withdrawals.¹⁴ Hence, there was no reason for Staff to suspect that there should be any
568 special consideration given to the LIFO inventory.

569 **Q. Mr. Feingold notes that**

570 **The Commission's Order approving the GCPP ... stated that, "Section 9-244**
571 **does not require that mechanisms which may generate customer savings be**
572 **specifically articulated." (Feingold Direct Testimony, p. 16, lines 371-374, in**
573 **part quoting page 39 of the Commission's Order in 99-0127)**

574 **Mr. Barrett also seems to allude to this finding (Barrett DT, p. 31, lines 655-659).**

575 **Do you believe that this finding by the Commission gave the Company the right to**
576 **hide the LIFO strategy from the Commission Staff and intervenors?**

577 **A.** No. The Company's carefully circumscribed presentation in Docket 99-0127
578 could easily have given the Commission the false impression that Nicor had only a few
579 vague notions about becoming a more efficient purchaser of natural gas. Taking the
580 Company at face value, the Commission quite reasonably chose to rely on the power of
581 the incentive program to induce the Company to produce savings. After all, the PBR
582 program was *supposed* to be predicated on giving the Company new incentives to be
583 innovative and efficient (more like firms in competitive unregulated industries), which

would hopefully result in lower rates and other substantial and identifiable benefits that would not otherwise be realized by customers.¹⁵

In contrast, the LIFO-derived savings are from gas purchased decades ago, hidden under Nicor's sleeve during Docket 99-0127, and later conjured up to create the illusion of PBR-induced savings. The Company did not need any incentives to identify the value of its storage inventory. The Company was already aware of that value. Nicor simply did not want to risk having ratepayers be the sole beneficiaries of that value.

Finally (and most compellingly), even if "Section 9-244 does not require that mechanisms which may generate customer savings be specifically articulated" for purposes of gaining approval of a PBR program, Section 9-244 certainly does not authorize utilities to withhold such information from Staff and intervenors in the course of proper discovery.¹⁶ By hiding this information in Docket 99-0127, the Company did

¹⁴ Docket 99-0127, Gilmore Rebuttal, p. 6.

¹⁵ See Docket 99-0127, Order, November 23, 1999, p. 38, quoted below, in part:

The Commission believes that one very important aspect of the proposed sharing mechanism is that it is consistent with the basic premise of incentive regulation, that companies with rate incentives are likely to be more efficient and productive than if there were no incentives. The risks and rewards inherent in the proposal, as modified by this Order, create the appropriate economic incentives for Nicor Gas to reduce gas costs. As such, the sharing mechanism produces a strong, objective economic incentive for the Company to take the additional steps, and assume the economic risks, necessary to achieve savings and avoid losses. Economic incentives such as those contained in the program, in turn, promote innovation, encourage efficiency, lower regulatory costs and encourage utilities to respond to new market challenges. The Commission therefore concludes that these benefits are substantial and identifiable benefits that will be realized by customers under the program that would not be realized in its absence as required by Section 9-244 (b) (2).

¹⁶ In Docket No. 99-0127, CUB submitted a data request to Nicor asking: "Please provide a copy of all projection, analyses and studies prepared which examine the extent to which the Company may profit under its proposal. Include copies of all communications which discuss the profit potential of the Company's proposal." On April 15, 1999, the Company submitted the following response: "The Company has not performed any projections, analyses or studies related to its potential performance under its proposal nor does the company have any communications which address the issue." (Docket No. 99-0127 Data Response CUB 27, April 15, 1999. However, the "Inventory Value Team Report," completed on or about October 1998, but provided to CUB and other parties only after the whistle-blower fax was revealed in June 2002, clearly examined the extent to which the Company could profit under a PBR proposal, citing potential savings of between \$100-\$200 million.

not simply prevent the Commission from learning of another vague Company notion about becoming more efficient; the Company severely compromised Staff's and intervenors' ability to evaluate the adequacy of the benchmark and the degree of risk inherent in the Company's proposal. Similarly, in the current docket (prior to July 2002), by failing to provide such information, the Company effectively sabotaged Staff and intervenors' ability to analyze whether the Program was meeting its objectives.

Q. Mr. Feingold seems to argue that the certain benefits of the LIFO strategy were needed to offset a general increase in risk brought about by PBR. He states,

On March 12, 2002, in the pre-reopening phase of Docket No. 02-0067, CUB submitted data request 1.17 to Nicor, which asked the Company to

identify or *estimate*, as applicable, the amount of savings achieved by each of the following:

- A. A more detailed and comprehensive planning process;
- B. Third-party arrangements to manage storage;
- C. Third-party arrangements to manage transportation;
- D. More active pursuit of sales of natural gas;
- E. Hedging strategies and financial tools for storage activities;
- F. Hedging strategies and financial tools for firm transportation;
- G. Hedging strategies for financial tools for managing market price volatility;
- H. *Managing storage differently* and testing operational boundaries by changing the timing of injections and withdrawals;
- I. The addition of two Gas Purchasing Departmental positions; and
- K. *Other (describe)*.
(emphasis added)

Nicor responded to this data request on March 27, 2002 as follows:

The amount of savings achieved by each of the items listed above is not available. Because the GCPP is a comprehensive benchmark, all of the above listed actions were taken toward the overall goal of reducing gas costs. Just as transportation and storage assets were utilized in conjunction with the commodity purchase decisions to achieve an overall reduction in gas costs, so too were the above actions utilized in an interconnected manner.

Subsequent to the whistleblower's memo, Nicor provided numerous documents directly contradicting its March 27, 2002 response, shown above. Among these subsequent documents are various "Buckets Reports," at least a dozen of which were created prior to the date of Nicor's above-quoted response to CUB 1.17. Some of these are after-the-fact reports that identify or show estimates of how the Company achieved savings in 2000 and 2001, while some of them are interim projections of such savings prepared prior to year-end. They all show the Company's computation of savings attributable to LIFO inventory decrements.

604 **The GCPP as approved by the ICC exposed Nicor Gas to new and**
605 **substantial risks in three broad areas, each of which contained a subset of**
606 **other risks to be managed. These risks were very different and much more**
607 **challenging relative to the risks the Company faced under traditional PGA**
608 **regulation. These three areas of risk were: (1) commodity risk; (2) storage**
609 **risk; and (3) fixed cost risk. In addition, as I will discuss below, these risks**
610 **were amplified by the extreme volatility in the gas markets during the GCPP**
611 **period. To address these risks, Nicor Gas was compelled to avail itself of all**
612 **available gas resource strategies, including the use of valuable Company**
613 **assets, such as the low-cost LIFO layers.**

614 **How does this affect your position that the Company's 50% share of the LIFO**
615 **benefit should be returned to ratepayers?**

616 A. It does not affect my position. In Docket 99-0127, it was certainly no secret that
617 the GCPP could increase the Company's risk (particularly if one ignored or remained
618 ignorant of the LIFO strategy). Indeed, Nicor made every effort to inform the
619 Commission that the Company's risk was increasing.¹⁷ The Company argued that this
620 increasing risk justified awarding Nicor a 50% share of savings rather than the 10% share
621 that Staff recommended.¹⁸ The Company made basically the same argument in the pre-
622 reopening phase of the current PBR Docket.¹⁹ In stark contrast, however, the Company
623 did not inform the Commission of its plans to tap into the LIFO layers to mitigate that
624 risk. Instead, in Docket 99-0127, Nicor apparently preferred to leave the Commission
625 with the one-sided view that the PBR would only increase the Company's risk. In the

¹⁷ For example, see Docket 99-0127, Werneke Direct, pp. 16-17; Elliott Surrebuttal, p. 2 (lines 17-19), p. 4 (lines 12-14), p. 8 (lines 1-15); Gilmore Surrebuttal, p. 8 (line 1).

¹⁸ The relationship between risk and the sharing mechanism was an important issue in Docket 99-0127. It is clear from the transcripts of oral arguments that at least one Commissioner (Kretschmer) was very concerned about risk sharing under the PBR, commenting, "As a rate payer of NICOR, I don't want to run the risk of having them lose money and I have to pay 90 percent of it and the company only pays 10 percent." (Transcripts from November 2, 1999 special open meeting of Commission to consider oral arguments in Docket 99-0127, pp. 85-86)

¹⁹ For example, Company witness McDermott opined, "This risk must be compensated by additional returns or the Company will not have an appropriate incentive to undertake actions that lead to greater efficiencies." (McDermott Rebuttal, p. 13)

pre-reopening phase of 02-0067, the Company talked about risk management, but never mentioned the LIFO strategy.²⁰ Hence, while the Company knew about the LIFO layers' implications for reducing risk and achieving savings under the benchmark, this information remained unknown by Intervenor, the Staff, and the Commission.

In Docket 99-0127, the Company could have made the LIFO strategy known to the Commission. It could then have made an argument for why the LIFO strategy's impact on risk should not affect the 50-50 sharing of LIFO savings. It could have sought the Commission's judgment, then. But to accept the Company's untimely arguments, now, would send the message that telling the Illinois Commerce Commission the half-truth and nothing but the half-truth is a viable and profitable tactic.

Finally, it must be recalled that, in Docket 99-0127, Nicor was under no obligation to propose a PBR program or to implement a PBR program after it was

²⁰ In a section of his direct testimony called, "Managing Risk," Company witness McDermott explained how the Company, during the first two years of the PBR program, dealt with commodity risk and storage risk. To combat commodity risk, Dr. McDermott explained how the Company utilized first-of-the-month ("FOM") swing contracts, so that "if cold weather causes daily prices to increase, the FOM contracts can be used to reduce gas costs compared to buying daily priced gas on that day." He also cited a variation in which the Company would purchase "more FOM-priced gas and a put option (i.e., the right to sell the gas at that price)." (McDermott Direct, p. 24) Odd that he didn't mention anything about tapping into the old low-cost LIFO layers, which Mr. Feingold now says was one of the ways that the Company offset commodity risk. As for storage risk, Dr. McDermott explained in the same "Managing Risk" section how "the Company's management of storage changed as a result of the incentives in the GCPP," noting that the Company entered into hedging arrangements in liquid futures and over-the-counter markets to lock in price differentials related to changed injection and withdrawal patterns. (McDermott Direct, p. 23) That doesn't sound like tapping into the old low-cost LIFO layers, either.

Furthermore, the Company failed to mention the LIFO strategy in its rebuttal testimony. For instance, in my Direct Testimony in this docket (02-0067), I proposed a three-tiered share-the-savings mechanism, with the Company earning a low, middle, and high share for low, middle, and high levels of savings, respectively. I defended this proposal, in part, on the assumption that there were probably some relatively easy savings opportunities ("low-hanging fruit") that the Company could pursue before attempting the more difficult, costly, or risky savings opportunities for which a larger company share would be more justified. In critiquing this proposal, Company witness McDermott testified, "[I]t is highly unlikely that 'low-hanging fruit' exists in the GCPP because the overwhelming majority of the cost incurred (i.e., gas costs) are benchmarked to objective measures of a competitive market place. One would not expect that 'low hanging fruit' would 'hang' for very long in the market." (McDermott Rebuttal, p. 15) In reality, though, there certainly was low-hanging fruit (i.e., the old LIFO layers), which hung around for multiple decades before being plucked by the Company.

modified by the Commission. For example, if the Commission had decided that net withdrawals from old low-cost LIFO layers should be netted off of PBR savings computations, the Company could have walked away from PBR. As specified in the Public Utilities Act, the Commission may require modifications to a PBR program, as long as those modifications are supported in the record as necessary to cause the program to satisfy the Act's criteria, but:

In the event the order identifies any such modifications it shall not become a final order subject to petitions for rehearing until 15 days after service of same by the Commission. The utility shall have 14 days following the date of service of the order to notify the Commission in writing whether it will accept any modifications so identified in the order or whether it has elected not to proceed with the program. (220 ILCS 5/9-244)

Thus, there was nothing that the Commission could have done to compel the Company to accept greater risk. If Nicor couldn't stand the heat, it could have stayed out of the kitchen.

3. Recommended Refund of LIFO Savings

Q. What is your recommendation with respect to this failure on the Company's part to provide Staff with the crucial storage information discussed above?

A. I recommend that the Company not be permitted to retain the 50% share of LIFO-derived savings that the PBR sharing mechanism automatically bestows upon Nicor. That is, I recommend that the Commission modify the share-the-savings formula to eliminate the Company's share of savings due specifically to the difference between the market cost of gas during the life of the PBR and the original cost of gas associated with net withdrawals. However, the level of those LIFO-derived savings is dependent upon the method of accounting for (1) the December 1999 sale to IMD, as well as (2) the

subsequent prefill deals that were entered between 2000 and 2002. In this regard, the next two sections of my testimony address the Company's original and restated accounting for these two sets of transactions, which I can summarize as follows:

For each of the PGA years under review, the restatement changes both the quantity as well as the average LIFO cost of net withdrawals. Prior to the Company's re-opening accounting restatement, there were net withdrawals in 2000, 2001 and 2002. Following the re-opening accounting restatement, net withdrawals are eliminated in 2001 and reduced in 2000 and 2002. Furthermore, prior to the restatement, 100% of the net withdrawals in 2000 through 2002 were from old low-priced LIFO layers. After the restatement, the net withdrawals in 2000 and 2002 are from a mix of old low-priced LIFO layers and newer more expensive layers. Nevertheless, even after the accounting restatement, there are still significant savings that can be directly attributable to net withdrawals.

Q. Have you computed the Company's 50% share of the net withdrawal savings existing in 2000 and 2002, following the Company's accounting restatement?

A. Yes. To perform this computation, one must make assumptions about when the net withdrawals actually occurred because market prices vary significantly, as shown below in the table of market index values used for the PBR benchmark.

Table 6. The Monthly Market Index (MI) throughout the PBR

	2000 MI	2001 MI	2002 MI
Jan	\$2.4376	\$10.0864	\$2.5345
Feb	\$2.6742	\$6.3332	\$2.1139
Mar	\$2.7139	\$5.2906	\$2.6458
Apr	\$2.9762	\$5.4986	\$3.4112
May	\$3.2948	\$4.7718	\$3.4548
Jun	\$4.4499	\$3.8000	\$3.3080
Jul	\$4.3087	\$3.1439	\$3.1537
Aug	\$4.0952	\$3.1292	\$2.9433
Sep	\$4.8578	\$2.2871	\$3.2897
Oct	\$5.3486	\$2.0803	\$3.8263
Nov	\$4.9498	\$2.9264	\$4.2151
Dec	\$7.3849	\$2.4109	\$4.3794
Avg	\$4.1243	\$4.3132	\$3.2730

There is no cut and dried means to make this determination. For simplicity, I recommend using the average for each year, which turns out to be \$4.12 and \$3.27 (per MMBTU) in 2000 and 2002, respectively. In comparison, the inventory withdrawal prices (as revised by the Company) were \$2.87 and \$1.32 (per MMBTU) in 2000 and 2002.²¹ When the difference in the average market price and the inventory withdrawal price is multiplied by the net withdrawals for each of the two years, the estimated savings due to tapping into the LIFO layers is \$22,031,074 for 2000 and \$19,658,357 for 2002. I propose that the Company's half (which is implicitly included in the revised computation of PBR savings) be credited back to ratepayers, amounting to an additional refund of \$20,844,715.

²¹ These revised inventory withdrawal prices represent a weighted average of more than one LIFO layer--some older relatively low-priced layers and some newer layers at contemporary prices. Originally, prior to the Company's accounting restatement, the inventory withdrawal prices for 2000 and 2001 were only 39 cents and 31 cents per MMBTU, respectively, while 2002 would also have been 31 cents per MMBTU.

It is notable that, without the accounting restatement of the prefill deals and the December 1999 sale to IMD, the original savings due to tapping into the LIFO layers in 2000, 2001, and 2002 were about twice the above value. See **Attachments 3** for a summary comparison and **Attachment 4** for a more detailed comparison of the pre-restatement versus post-restatement savings due to LIFO layers.

4. Effect of Previous Net Withdrawals from Storage Inventory on the Original Creation of the PBR Benchmark in Docket 99-0127

Q. Did the value of net withdrawals relative to market values play any part in the original creation of the benchmark?

A. Yes. During the creation of the benchmark, the commodity adjustment rate of 1.68 cents per MMBTU was computed, by comparing actual costs in years 1994 through 1998 to all the other components of the benchmark (excluding the commodity adjustment). Computed separately for each year, the commodity adjustment rate was basically the residual costs per MMBTU that was not explained by the other three components of the benchmark (the market index, the storage credit adjustment, and the firm deliverability adjustment). During those five years, Nigas had the following net withdrawals from storage (with 1996's negative value indicating a net injection):

Table 7. Net Withdrawals from Storage

1994	2,325,317
1995	2,242,870
1996	-19,208,257
1997	1,325,789
1998	7,745,831

However, unlike the 2000 to 2002 period, the average withdrawal prices from the LIFO layers accessed during the period 1994 to 1998 were above (rather than below) average

market prices at the time. Hence, the net withdrawals during 1994, 1995, 1997, and 1998 led to an increase in the Company's costs relative to purchases at the market index (and a corresponding increase in the commodity adjustment component of the benchmark computed in Docket 99-0127). The 1996 net injection had very little effect, because, as expected, the difference between the average injection price and the average market index price in that year is very small. Over the five-year period, the net increase in the Company's costs relative to purchases at the market index amounted to about \$10.8 million.

Q. Have you quantified the impact of the 1994-1998 net withdrawals on the commodity adjustment factor that was developed during in the 99-0127 case?

A. Yes. After computing the impact of these net withdrawals and applying the weights ordered by the Commission in Docket 99-0127, Staff has determined that the impact on the commodity adjustment rate computed in Docket 99-0127 was to increase it by 0.8 cents per MMBTU. That is, of the fixed commodity adjustment rate of 1.68 cents per MMBTU that was computed in Docket 99-0127, almost half of that value can be explained by the excess cost of withdrawing gas from storage versus buying gas at market prices prevailing during the 1994-1998 period.

Q. Have you quantified the impact of this increase in the commodity adjustment factor on the benchmark used during the life of the program (2000 through 2002)?

A. Yes. Over the three years during which the PBR program was in effect, deliveries to customers totaled 769,633,962 MMBTU. Applying this total volume of deliveries to the 0.8 cents per MMBTU, determined above, results in a total impact of about \$6

million. Hence, even if there had been no direct LIFO layer savings during the life of the PBR program, the Company would have automatically generated indirect savings of about \$6 million through the commodity adjustment, due to the effect of LIFO layers on the original creation of the PBR program benchmark. Of course, the 50-50 sharing of the PBR program has permitted the Company to retain half of those “savings.” While one might dispute the fairness of this, Staff is not recommending any adjustment associated with these indirect LIFO/commodity adjustment savings, because Staff has uncovered no evidence that the Company purposefully created or hid the pre-program (1994-1998) net withdrawal losses in order to inflate the commodity adjustment.

B. Sale to IMD in December 1999

Q. What happened in December 1999?

A. Company records show that Nicor Gas transferred to IMD a significant amount of storage capacity in a DSS storage service account with pipeline company NGPL. Along with the capacity, the Company transferred to IMD 18.8 million MMBTU of gas held in inventory.²² The transaction significantly contributed to a large net withdrawal from storage inventory in 1999.²³ This net withdrawal enabled the Company to completely eliminate the two high-priced storage inventory layers that existed as of the beginning of 1999: the 29 cent per therm 1996 layer and the 32 cent per therm 1984 layer. As previously noted, this positioned the Company to begin withdrawing the much lower-priced gas in the pre-1984 layers of the inventory during the tenure of the PBR program,

²² Before the end of the year, Nicor bought some of that 18.8 million MMBTU of gas back from IMD at the same price, so the net sale in December 1999 was for 16.1 million MMBTU.

²³ The December net sale of 16.1 million MMBTU to IMD formed 58% of Nicor’s 1999 total net withdrawals from storage (pre-restatement).

where the Company would be able to share in half the “savings” from avoiding the purchase of higher-cost gas at contemporary market prices.

Q. What was wrong with this sale to IMD in 1999?

A. First, and most significantly, the timing of the sale saddled ratepayers with the entire burden of the high-priced gas layers, after which the Company would then take half the windfall savings associated with withdrawing the remaining low-priced inventory. I believe that the Company’s accounting restatement (discussed below) adequately addresses the fact that the sale’s contribution to costs would be born entirely by ratepayers in 1999, but shared in 2000.

Second, the sale took place at the beginning of the winter and at a time when gas prices were expected to be rising (judging by futures prices at the time of the sale). Indeed, prices did rise throughout 2000, and ratepayers ended up paying more when the gas (originally sold to IMD in December 1999) was subsequently bought back at higher prices. However, the Company’s accounting restatement does not address this effect on gas costs, so I recommend an additional adjustment, below.

Q. How has the Company addressed this sale to IMD in its re-opening accounting restatement?

A. The Company’s restatement basically pretends that the sale never took place. Instead, the Company’s restatement pretends that the sale to IMD was actually a loan from IMD (in order to account for the influx of cash in December 1999). What were subsequent purchases from IMD are now treated, under the restatement, as “loan” repayments. By reversing the sale to IMD in 1999 and the subsequent repurchases of that

gas, the restatement also decreases net withdrawals from storage in 1999 and increases them in 2000. The net effect of the restatement is to postpone until 2000 the inclusion in the PGA of the December 1999 accounting losses. Since half of all losses in 2000 were shared with ratepayers, this approach leads to a net rate reduction of about one-half the original losses (approximately one-half of \$13 million).²⁴

However, even after reversing all the original accounting entries for the sale to and subsequent purchases of gas back from IMD, the Company still paid more for gas than it would have if the sale really had never taken place. This is because the market price of gas was higher in 2000 than it was in December 1999. Had the Company actually waited until sometime in 2000 to enter into the transaction with IMD, it would have received a better price on the sale, and net gas costs would have been lower.

On the other hand, the Company and IMD agreed to share in IMD's profits from these transactions, which took into account the original sale price to IMD, the subsequent sale price back to Nicor, as well as various financial transactions made by IMD to hedge its profits. Nicor's proceeds from this agreement partially offset the losses suffered by ratepayers.²⁵

Q. Have you quantified the additional increase in gas costs that resulted from prematurely selling the gas to IMD in December 1999?

A. Yes. Had the Company withdrawn the gas during the first quarter of 2000, rather than in December 1999, and waited to transfer the capacity to IMD until the second

²⁴ This seems to be consistent with the recommendation of Mr. Lassar (see Lassar Direct Testimony, pp. 10-12).

²⁵ Those profit sharing proceeds amounted to \$3.6 million, according to KPMG 026413-026414, and supported by 026519-026524, and 026553.

quarter of 2000, Nicor would have avoided about \$6.3 million in costs, less the \$3.6 in profit sharing it got back from IMD, leaving \$2.7 million. Based on this computation, I recommend a cost disallowance for 2000 of \$2.7. Given the 50-50 sharing formula, this adjustment leads to a refund to customers of about \$1.35 million.

C. NICOR's Prefill Program

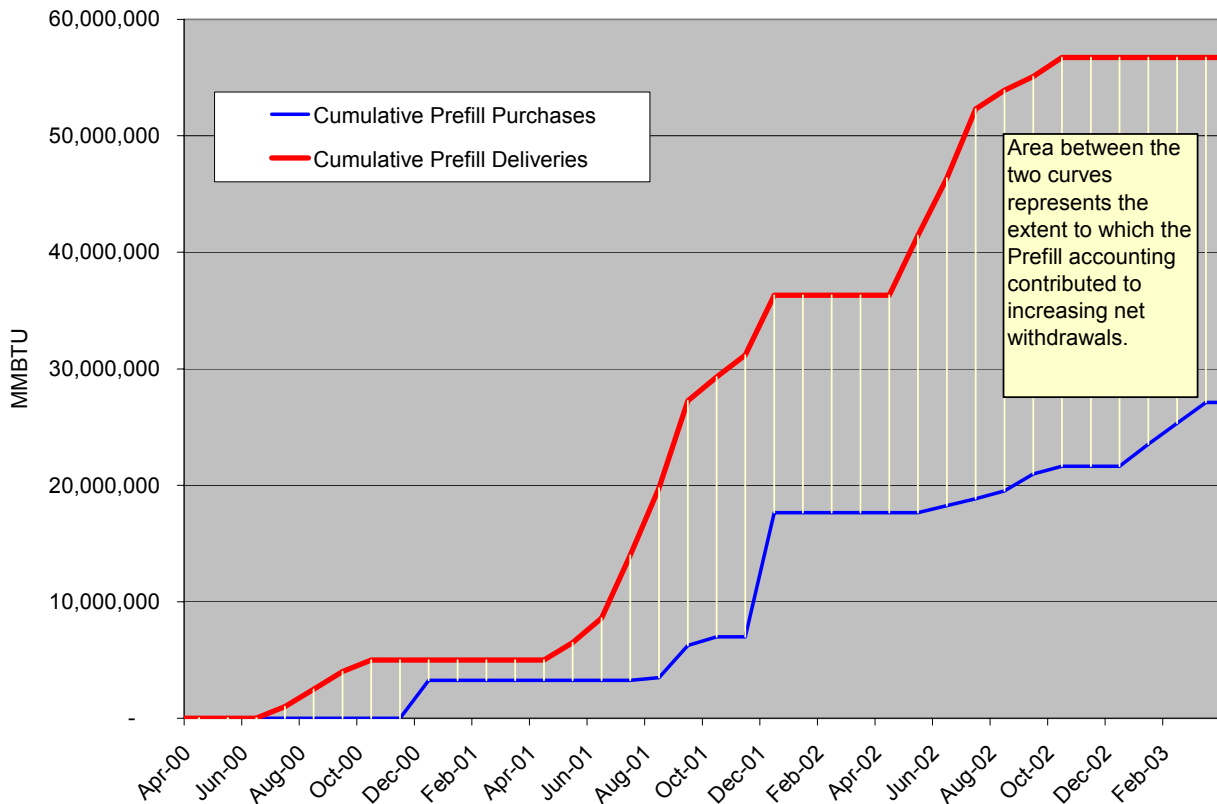
Q. What was the purpose of the Company's "prefill" program?

A. As previously noted, the Company was keen to increase its net withdrawals from its storage inventory during the life of the PBR program. This would generate "savings" as the PBR program implicitly compared contemporary market prices to the much smaller prices that existed in the 1960s and early 1970s, when the relevant LIFO layers of the storage inventory were created. The prefill strategy gave the Company greater control over annual net withdrawals, without jeopardizing any operational priorities. In addition, the prefill strategy enabled the Company to double-collect for carrying charges.

Q. How did the prefill strategy give the Company greater control over annual net withdrawals?

A. In effect, the strategy was to purchase significant quantities of gas on credit. That is, the seller would deliver the gas to the Company at one point in time, but Nicor Gas would pay them for it at a later point in time. In fact, significant quantities were not paid for until the following year or later. By the end of 2002, most of the gas delivered to the Company as "prefill" had still not been paid for (See Figure 1 below).

Figure 1. Graph showing how postponing purchases from prefill accounts enabled the company to extend its reach into LIFO inventory



From the storage accounting standpoint, while prefill deliveries were contributing to the increase in the Company's storage inventory throughout the year, they were also being explicitly deducted. That is, they were being treated as transportation customer-owned injections and, as such, were deducted from total physical injections. They were not added back again until the Company eventually paid the vendor for the gas. Nevertheless, it is important to understand that the prefill deliveries and the later prefill purchases are not explicitly tied to any physical storage activity; that is, they cannot be tangibly matched with injections and withdrawals, respectively. However, from the storage *accounting* standpoint, subtracting *X* therms and always adding back *less than X* therms, in any given year, effectively decreases "net injections," or stated equivalently,

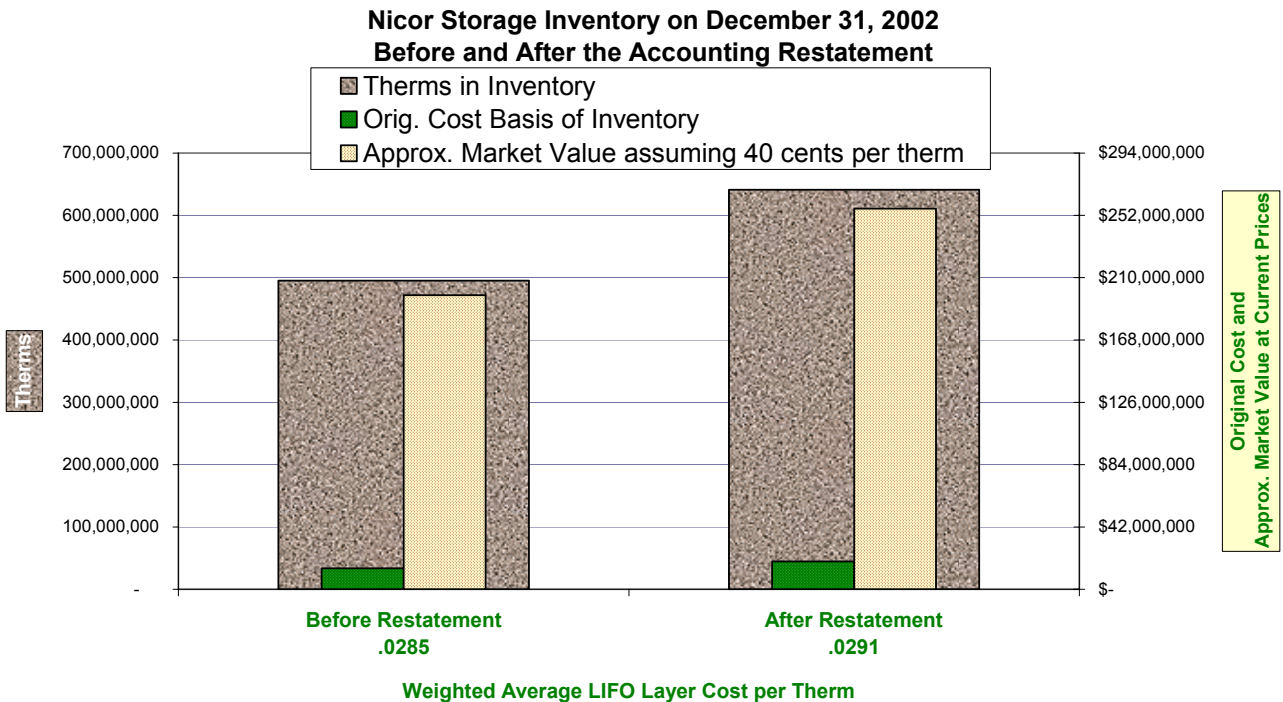
increases “net withdrawals” for that year. Thus, as illustrated in Figure 1 above, lagging prefill purchases behind prefill deliveries enabled the Company to control the size of net withdrawals and extract more from its heirloom LIFO layers.

Q. Is there anything wrong with the prefill accounting, described above?

A. This issue is addressed by Staff accounting witness Mary Everson. However, it is my understanding that for most of the prefill deals, the accounting process employed by the Company may have violated certain accounting standards, such as FAS49. Thus, much of the prefill accounting has been restated by the Company, in many cases resulting in a purchase being recorded at the time of the prefill deliveries (rather than at the time of the actual payments). This has a significant effect on the computation of net withdrawals, significantly reducing them. In fact, the restatement completely eliminates net withdrawals in 2001, instead leaving net injections. As previously discussed (in section A), the reduction in net withdrawals basically lowers the PBR “savings” associated with tapping into the old low-cost LIFO layers of storage inventory. However, as shown in Figure 2 below, reversing the prefill accounting has also preserved more of the low-cost gas in inventory, leaving an additional 14.6 million MMBTU worth about \$58 million (at an assumed market price of \$4 per MMBTU).

848

Figure 2. Effect of Accounting Restatement on Size of Storage Inventory



849

850 **Q. How did the prefill strategy enable the Company to double-collect for carrying**
851 **charges?**

852 **A.** During rate cases, it is common Commission practice to include a return on rate
853 base, including a return on the cost of gas in storage inventory. For this purpose, a test
854 year is used to compute the average value of gas in inventory. In the Company's 1995
855 general rate case, the Company's approved cost of service study had \$301,037,000 of rate
856 base classified as underground storage plant, most of which is the cost of gas in storage.
857 Applying the overall allowed rate of return of 9.67% implies a carrying charge recovery
858 of \$29,110,000. (See Company's Aug 12, 2002 response to ICC 2.06) To avoid double-
859 recovery, the Commission's PGA rules prohibit the inclusion and recovery of carrying
860 charges on gas in storage. However, with the prefill deals, where the Company
861 purchased gas on credit, the Company either explicitly or implicitly paid carrying charges

to vendors for gas delivered to the Company. These explicit and implicit carrying charges associated with the prefill strategy were included in the ultimate price paid by the Company, included in the PGA, and recovered from ratepayers. Since this occurred while the PBR program was in effect, Nicor absorbed one-half of these additional carrying charges. However, at the same time, Nicor saved the full amount of direct carrying costs that it would have incurred had it purchased these quantities at the time of delivery. Thus, Nicor Gas incurred about the same actual carrying charges it would have without the prefill deal, received base rate recovery for such carrying charges, and received additional PGA revenue for one-half the actual carrying charges associated with the prefill deals. On net, the Company was ahead by approximately one-half the actual carrying charges associated with the prefill deals.

Q. What do you recommend as the remedy for this double-collecting for carrying charges?

A. I recommend that the Commission order a refund of one-half the explicit and implicit carrying charges associated with the prefill deals, which were included in the PGA.

Q. How should the refund for explicit carrying charges be computed?

A. Some of the deals were priced at a current market index (at time of delivery to Nicor Gas) plus explicit carrying charges (up to the time of payment). Thus, it should be a simple matter to alter the accounting entries to book the price of gas when the deliveries took place, leaving off carrying charges that would have been accruing during the year. At the same time, any subsequent purchases of such prefill gas during the 2000-2002

period can be removed from the purchases that were booked. Indeed, this is my understanding of how the Company has reversed the accounting of those prefill deals that were explicitly priced at market index at time of delivery plus carrying charges. Thus, the exclusion of the explicit carrying charges occurs automatically with those corrections.

Unfortunately, not all of the prefill deals were priced at the current market index plus carrying charges. For instance, some of the deals were pegged to the future value of market indexes, and did not include explicit carrying charges. In such cases, removing carrying charges may have to rely upon assumptions about the level of carrying charges implicitly included in the purchase price paid by Nicor Gas under this latter category of prefill deals.

Q. How should the refund for implicit carrying charges be computed?

A. I recommend using the same type of computation that was performed by the Company in the more straightforward prefill deals. That is, we would add a calculation of interest to the value of the prefill gas at the time it was delivered, at the type of interest rates used in the deals with explicit carrying charges. The Company, for purposes of the PGA, would be required to deduct from its total cost these imputed carrying charges. However, I recommend deducting imputed carrying charges, for each pre-fill deal, only to the extent that the actual costs exceeded the costs that would have existed under the index plus carrying charges pricing. Thus, the Company shoulders the risk of absorbing

imputed carrying charges, while customers absorb the risk of market price fluctuations that exceed those carrying charges.²⁶

Q. Have you computed the amount of implicit carrying charges that should be deducted from PGA purchase costs during the life of the PBR program?

A. Yes. There are none for 2000. There are \$604,980 for 2001, and \$2,437,060 for 2002, for a total of \$3,042,040 to be excluded from the 2001 and 2002 gas costs. Given the 50-50 sharing mechanism, the Company would absorb one-half of this amount and ratepayers the other half. On net, this adjustment leads to a net refund of \$1,521,020. Additional implicit interest continues to accrue in 2003 and should be deducted from the PGA in 2003 (and afterwards if necessary).

D. The Company's Improper and Inaccurate Computation of the Storage Credit Adjustment

Q. Please remind us of the role of the storage credit adjustment in the PBR program?

A. Recall that the Storage Credit Adjustment ("SCA") represents the difference in the value of gas when it was withdrawn from storage and the value of gas when it was injected into storage. To represent this value, the SCA uses fixed monthly weights and actual monthly market prices to compute an annual storage credit rate, which is then multiplied by actual annual storage withdrawals. Thus, this SCA fluctuates from year to year due to the movement in market prices and to changes in annual storage withdrawals. When the SCA is positive, it implies that gas was more valuable during the withdrawal

²⁶ While subjecting customers to such additional risk is probably not what the Commission had in mind when it approved the PBR program, the Commission did not explicitly prohibit the Company from basically unwinding the natural hedge associated with normal storage operations. Staff sees no basis for claiming these deals were either imprudent or somehow violated the Company's tariff or Commission rules.

season than the injection season and thus, the use of storage is likely to decrease costs. Hence, the SCA is subtracted from the other components of the benchmark (so an increase in the SCA is a decrease in the benchmark, while a decrease in the SCA is an increase in the benchmark).

Q. Please explain what the Company did wrong in computing the storage credit adjustment.

A. My analysis reveals that the Company's practices hid a significant portion of storage withdrawals. As shown later in this testimony, this had the effect of slightly increasing the SCA and decreasing the benchmark in 2000 and 2002 (bad for the Company because it *reduced* computed savings), but more significantly decreasing the SCA and increasing the benchmark in 2001 (good for the Company because it *increased* computed savings).

Q. How did the Company's practices hide a significant portion of storage withdrawals for sales customers?

First, the Company adjusted withdrawals by subtracting "in-field transfers." In subsection 1, below, I will argue that the Company's in-field transfer adjustments should not be made because no such adjustments were made prior to the inception of the GCPP, including the historical period upon which the Program's Commodity Adjustment was based. In Docket 99-0127, if in-field transfers had been accounted for during the historical period upon which the Commodity Adjustment was based, the implied historical storage savings would have been smaller and hence the computed Commodity Adjustment also would have been smaller. Had the Company subtracted in-field storage

transfers from the storage withdrawal data used in Docket 99-0127, it would be justified in making similar adjustments to the 2000 and 2001 storage data. However, the Company just started making these in-field transfer adjustments since the GCPP went into effect. I will show later that “in-field transfers” are not new. In fact, by examining storage injection and withdrawal data from January 1995 through December 2002, there does not appear to be a significant difference in the amount of in-field transfers before and after the GCPP went into effect. The only change since the GCPP went into effect is that Nicor Gas began explicitly accounting for the in-field transfers and began using them as the basis for reducing the volumes used in the storage credit adjustment.

Second, since the GCPP was approved toward the end of 1999, Nicor Gas released significant quantities of NGPL purchased storage capacity to third parties. As the third parties withdrew gas out of these NGPL storage accounts, they no longer appear as the Company’s storage withdrawals. Instead, they appear as Company purchases. Hence, the storage credit adjustment is reduced proportionally. The Company did not necessarily adopt this strategy simply to alter the benchmark. The Company may have been counting on the third parties to better manage the storage resources and create savings opportunities through such improved management. Nevertheless, as I argue in subsection 2, below, the Company was still expected to benefit from that use of storage and should have accounted for the withdrawals in computing the GCPP benchmark. Notably, in 2000, when the storage credit rate turned out to be “inverted” and the Company stood to gain by increasing reported withdrawals, the Company took steps to partially reverse the hidden withdrawals associated with the released NGPL capacity.

Specifically, under the name “virtual storage,” the Company made a positive accounting adjustment of the same magnitude to both withdrawals and injections.

In Staff’s opinion, the Company’s exclusion of both in-field transfers and withdrawals from NGPL storage managed by third parties should be added back into the computation of “withdrawals” for purposes of computing the storage credit adjustment component of the benchmark. These two separate but related issues are addressed more fully in the following two sub-sections.

1. In-field Transfers

Q. What is an in-field transfer?

A. From the Company’s response to Staff data request ICC 6.05 on September 10, 2002,

Storage volumes are transferred between storage fields when Nicor Gas physically withdraws gas from one or more storage fields on the same day that it is physically injecting gas in other storage fields. In-field transfers result in physical injections and withdrawals and are undertaken for operational reasons related to storage field management.

Q. Have you examined the data supporting the Company’s identification of specific quantities of in-field transfers?

A. Yes. First, in response to a Staff data request, the Company provided a series of memoranda that noted specific dates upon which in-field transfers took place in 2000 and 2001 (NIC 010143-010154) and in response to ICC 1.09, the Company provided, among other data, a monthly summary of in-field transfers for 1995 through 2002. These responses reveal that the Company did not attempt to identify any in-field transfers prior

to 2000, and that it identified in-field transfers in only one month in 2000, ten months in 2001, and no months in 2002.

Second, by examining daily data on storage injections and withdrawals provided in response to Staff data request ICC 1.11, I sought to independently “find” evidence that in-field transfers had taken place during the period 1995 through 2002. In accordance with the Company’s own definition, I looked for when “Nicor Gas physically withdraws gas from one or more storage fields on the same day that it is physically injecting gas in other storage fields.” When injections in some fields and withdrawals in other fields were both positive on the same day, I quantified the in-field transfer as the minimum of the injections and withdrawals on that day. For any given month, in-field transfers would be the sum of those daily minimums of injections and withdrawals. The results of this analysis are summarized in Table 8, below.

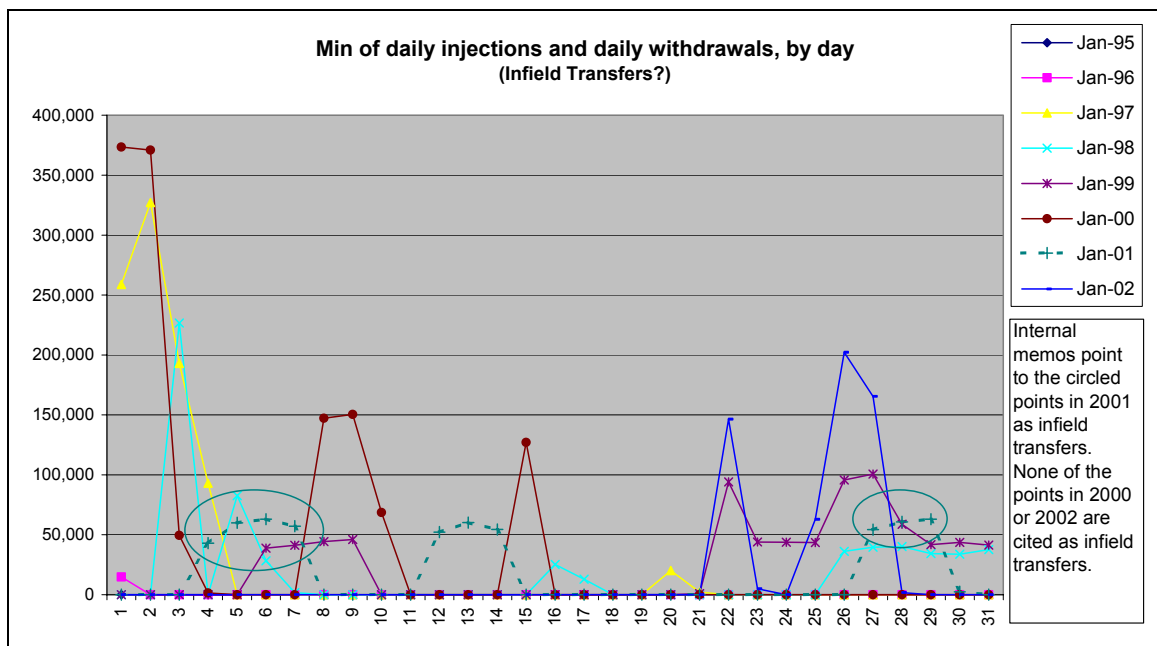
Table 8. Infield Transfers Derived by Staff

Infield Transfers derived from ICC 1.11 data								
Sum of Sum	Yr							
Mo	1995	1996	1997	1998	1999	2000	2001	2002
1	0	14,743	894,224	598,936	778,161	1,288,633	570,320	583,520
2	0	1,978,779	236,391	488,477	914,885	1,495,855	0	0
3	1,067,409	2,587,064	443,846	434,134	275,780	1,452,503	417,382	153,255
4	1,679,530	1,505,363	1,348,731	1,416,485	264,151	1,546,261	844,079	268,468
5	987,187	38,340	1,344,449	1,342,331	473,075	1,011,810	121,236	1,281,558
6	779,550	0	715,789	962,269	1,490,638	354,682	292,271	866,111
7	125,775	461,800	168,982	1,418,278	790,976	269,865	0	215,065
8	39,612	325,234	0	754,227	508,088	530,505	291,528	0
9	31,913	0	58,535	157,033	0	0	524,230	0
10	0	463,375	914,981	696,964	4,453,283	1,508,269	1,500,161	2,178,679
11	7,645,570	5,265,449	3,966,149	4,861,831	5,250,395	3,811,645	5,678,595	4,446,742
12	819,588	3,443,918	0	0	2,817,273	506,406	2,768,109	617,217
average	1,098,011	1,340,339	841,006	1,094,247	1,501,392	1,148,036	1,083,993	884,218
Total	13,176,134	16,084,065	10,092,077	13,130,965	18,016,705	13,776,434	13,007,911	10,610,615

Using this methodology, I came relatively close to deriving the same level of in-field transfers originally reported by the Company for 2001; however, my results and the Company’s originally reported in-field transfers diverge significantly for 2000 and

2002.²⁷ For example, note the graph of daily in-field transfers for January of years 1995 through 2002, shown in Figure 3 below. The days specifically cited as infield transfers in internal Nicor memoranda (and excluded from withdrawals in the PBR's storage credit adjustment computations) are circled. Although Nicor's internal memoranda only cite in-field transfers for 2001, the data nevertheless reveal even greater in-field transfer activity in 2000 and 2002. A comparison of the Company's results and my results, on an annual basis, is shown further below in Table 9 (p. 54).

Figure 3. January In-field Transfers



Broadly speaking, my analysis also shows that the same general level of in-field transfers existed for **all** the years in the ICC 1.11 daily storage data (1995 through 2002). In other words, in-field transfers are not new. The Company's explicit identification and quantification of them appears to be the only thing new. The Company began this

²⁷ Following the Lassar Report, the Company restated in-field transfers for 2002 using apparently the same methodology that I used—getting the same results.

identification and quantification process when it thought it would benefit from it (by reducing the size of the storage credit adjustment, enabling the Company to compute and share in greater “savings” under the GCPP). Furthermore, the Company’s specific identification of in-field transfers appears to have been the most vigorous in 2001, when it benefited the Company the most.

Q. Why did it benefit the Company the most to identify in-field transfers in 2001?

A. In-field transfers reduced both injections and withdrawals equally. Thus, they have no effect on the accounting of gas costs, but they do have an effect on annual withdrawals, which is a component of the SCA. The other component of the SCA is the winter-summer price differential. In 2001, there was a significantly positive winter-summer market price differential. Therefore, reducing reported withdrawals for 2001 would reduce the storage credit adjustment component of the benchmark, thus increasing the overall benchmark and the Company’s reporting of “savings.” In contrast, the winter-summer differential was negative in 2000 and 2002, so that reducing reported withdrawals would increase the storage credit adjustment, thus lowering the overall benchmark and savings. Table 9, below, shows the actual SCA rate for each of the years the PBR program was in effect, along with the total infield transfers originally reported by Nicor.

Table 9. Storage Credit Adjustment Rates and Annual In-field Transfers

Year	SCA Rate (per MMBTU)	In-Field Transfers Originally Reported by Nicor (MMBTU)	In-Field Transfers Computed by Staff from ICC1.11 data (MMBTU)
2000	(\$0.686)	738,661	13,776,434
2001	\$2.750	12,059,367	13,007,911
2002	(\$0.326)	0	10,610,615

Q. Was the Company aware of the winter-summer differentials when it went about the process of identifying (or ignoring) in-field transfers?

A. I don't know the answer to that. However, even before each of the years began, futures market prices could have given the Company a clue to projecting the SCA rate. Table 10, below, shows the storage credit adjustment rates that would have been projected by the 12-month strips of futures prices that existed just prior to the start of each year. As one can see, the implied SCA rate for 2000 and 2002 were relatively small, compared to the implied SCA rate for 2001, which was almost as large as the actual SCA by the end of the year.

**Table 10. Storage Credit Rates
Implied by 12-month Futures Strip Compared with Actual**

Year	Futures Transaction Date	SCA Rate Implied by Futures	Actual SCA Rate
2000	12/28/1999	\$0.043	(\$0.686)
2001	12/27/2000	\$2.469	\$2.750
2002	12/27/2001	(\$0.006)	(\$0.326)

Q. Do you have any reason to suspect that the Company was specifically identifying and quantifying in-field transfers for purposes of manipulating the PBR benchmark?

A. Yes, I would point to the Lassar Report, where it refers to Nicor employee Tara Algreen, who was specifically responsible for designating in-field transfers. The report states

Algreen says she felt pressured to record in-field transfers. Algreen attended daily meetings where the operational needs of the aquifers and the ratepayer needs were discussed. In the fall of 2001, Algreen says individuals from Gas Supply at these meetings made comments that

1062 *transfers which Algreen stated would occur on the given day should be*
1063 *categorized as in-field transfers.*²⁸

1064 In addition, the Lassar team's workpapers include an October 22, 2002 memorandum
1065 summarizing an interview with Ms. Algreen that purportedly took place on September 6,
1066 2002 (with Mr. Lassar and other members of his team in attendance). According to this
1067 memorandum,

1068 *When questioned who asked Algreen to record injections and withdrawals*
1069 *as in-field transfers, Algreen recalled that when Purchasing wasn't hitting*
1070 *their targets, they would say we can only withdraw this much, especially*
1071 *in November 2001 when withdrawals were too high because it would*
1072 *negatively effect their benchmark.*²⁹

1073 *Algreen also stated that as early as April 2001, during a morning meeting,*
1074 *someone from Gas Supply Purchasing told her to consider everything to*
1075 *be a transfer.*³⁰

1076 *Algreen stated that she did not understand the extent of the impact on the*
1077 *PBR of calling all withdrawals in-field transfers at the time she was told*
1078 *to do so. Later, Steve Botten told Algreen he spoke with someone in*
1079 *Accounting who told him the in-field transfers had a \$30 million impact*
1080 *on the PBR.*³¹

1081 *Algreen recalled that no in-field transfers had been recorded in 2002. ...*
1082 *Algreen was not asked by anyone to track in-field transfers; she believes*
1083 *that there was a lot of uncertainty concerning whether the PBR would*
1084 *continue. ... Algreen asked Lonnie Upshaw if she should continue*
1085 *tracking the in-field transfers and Lonnie said, "No, the PBR can handle*
1086 *it."*³²

1087 **Q. Do any of your conclusions or recommendations hinge on the possibility that the**

²⁸ Lassar Report, October 28, 2002, p. 52 (NIC 049853)

²⁹ KPMG 027540

³⁰ KPMG 027541

³¹ KPMG 027543. The actual impact of the Company's originally reported 2001 in-field transfers was more like a \$33 million change in PBR "savings" (\$2.75/MMBTU times 12 million MMBTU), half of which would be retained by Nicor.

³² KPMG 027542

1088 **Company was identifying and quantifying in-field transfers for purposes of**
1089 **manipulating the PBR benchmark?**

1090 A. No.

1091 **Q. Company witness Barrett conjectures,**
1092 **No one disputes the fact that those withdrawals made for operational**
1093 **purposes (i.e., infield transfers) should have been excluded from the**
1094 **calculation of the SCA. (Barrett Direct, p. 20, lines 425-427).**

1095 **Is Mr. Barrett correct?**

1096 A. Absolutely not. In my opinion, in-field transfers should not have been excluded from the
1097 calculation of the SCA.

1098 **Q. Why should the Commission include in-field transfers in the computation of the**
1099 **storage credit adjustment, rather than exclude them as the Company has done?**

1100 A. If the Company, in Docket 99-0127, had originally proposed excluding in-field
1101 transfers, it is unlikely that Staff would have been opposed. Staff agrees that measuring
1102 net daily injections or withdrawals is just as valid if not a more valid means of measuring
1103 storage activity for purposes of a storage credit adjustment. However, the Company did
1104 not make that proposal. Furthermore, had the Company made that proposal, it would
1105 have had ramifications for another component of the benchmark, namely the
1106 “Commodity Adjustment.” Recall from my earlier testimony that the Commodity
1107 Adjustment (“CA”) is basically a catch-all or residual adjustment. In Docket 99-0127, it
1108 was set to a level that, on average, over several historical years, would have equated the
1109 total benchmark gas costs with the Company’s actual historical gas costs. That is, the
1110 average savings would have been zero. To compute the CA, actual gas costs were

compared to the benchmark's other components (including the storage credit adjustment) for several historical years ($t = 1994$ to 1998). In essence:

$$CA_t = (\text{Actual Costs}_t - \text{MPI}_t - \text{FDA}_t + \text{SCA}_t) \div \text{Use}_t,$$

where MPI is the market price index,
FDA is the firm deliverability adjustment, and
SCA is the storage credit adjustment.

An average of the CA_t resulted in the fixed commodity adjustment rate of 1.68 cents per MMBTU, which has been applied to the Company's actual deliveries to customers during the tenure of the PBR program (2000-2002). Had the Company excluded in-field transfers from the historical data used to compute this residual CA, the storage credit (which was positive in each of the historical years examined) would have been smaller in each year. Hence, the CA_t would have been smaller in each year, as would the final average CA selected by the Commission.

But the Company apparently wanted to "have its cake" (the higher CA computed in 99-0127 with in-field transfers included) "and eat it too" (subsequently remove in-field transfers and raise the benchmark even more while the program was in effect from 2000-2002).

Q. You propose to recompute the 2000-2002 benchmark, by including rather than excluding in-field transfers. Would it be just as reasonable to go back and recomputed the CA to exclude in-field transfers in the historical data used in Docket 99-0127, and then allow the Company to exclude in-field transfers from the 2000-2002 benchmark calculations?

1133 A. No. While it would be better than nothing, settling for such an alternative remedy
1134 would be rewarding the Company for what is, at best, creative accounting. Furthermore,
1135 as previously explained, the alternative method of computing the CA and storage credit
1136 adjustment (i.e., without in-field transfers) was not a part of the Commission's approved
1137 benchmark. By excluding in-field transfers, the Company basically took it upon itself to
1138 unilaterally alter the Commission-approved PBR program (without so much as notifying
1139 the Commission or the Commission Staff). So of course, I do not believe that the
1140 Commission should settle for this alternative remedy.

1141 **Q. What is the effect of adding back in the in-field transfers that the Company**
1142 **removed?**

1143 A. In the two years in which the storage credit adjustment rate was inverted, adding
1144 back in-field transfers reduces the storage credit adjustment and thus increases the
1145 benchmark by \$506,943 (2000) and \$3,460,131 (2002). In the other year, adding back
1146 in-field transfers increases the storage credit adjustment and decreases the benchmark by
1147 \$33,166,877 (2001). On net, making these corrections to the benchmark leads to a total
1148 refund of \$14,599,901 (half the total reduction in the benchmark).

1149 **Q. How does your position with respect to in-field transfers differ from the Company's**
1150 **re-opening position on this issue?**

1151 A. My position is that any in-field transfers that were removed by the Company
1152 should be added back to the computation of withdrawals. The Company's re-opening
1153 position is to continue removing in-field transfers, but to adopt a more uniform and
1154 mechanical method of computing them. The table below, shows the Company's

originally computed in-field transfers (except for 2002) and the Company's revised in-field transfers, along with their effect on the storage credit adjustment.³³ Staff's proposal eliminates the Company's original \$29,199,803 in storage credit adjustments due to in-field transfers, returning half of that, or \$14,599,901, to ratepayers. In contrast, the Company's re-opening proposal reduces the storage credit adjustments from \$29,199,803 to \$22,299,803 (a reduction of \$6,900,000), returning half of that, or \$3,450,000, to ratepayers. In other words, under the Company's approach, ratepayers still end up paying an additional \$11,149,901 because of the Company's revised computation of in-field transfers.

Table 11. In-Field Transfers and their Effect on Ratepayers through PBR

	2000	2001	2002	Total	
	MMBTU	MMBTU	MMBTU	MMBTU	
Co Original	738,661	12,059,367	10,610,645	23,408,673	
Co Revised	14,872,422	13,077,438	10,610,645	38,560,505	
Co Increase	14,133,761	1,018,071	-	15,151,832	
SCA Rate	(0.6863)	2.7503	(0.3261)	Total	-Effect on SCA / 2
					=
	Effect on SCA	Effect on SCA	Effect on SCA	Effect on SCA	Effect on Rates
Co Original	\$506,943	(\$33,166,877)	\$3,460,131	(\$29,199,803)	\$14,599,901
Co Revised	\$10,206,943	(\$35,966,877)	\$3,460,131	(\$22,299,803)	\$11,149,901
Co Increase	\$9,700,000	(\$2,800,000)	\$0	\$6,900,000	(\$3,450,000)

2. NGPL Storage Withdrawals by IMD for Nicor Gas

Q. Why should the NGPL Storage Withdrawals by IMD be included in the storage credit adjustment component of the benchmark?

A. First, the storage service in question was included in the Company's PGA mix during the historical period over which the Commodity Adjustment was computed in

³³ Actually, the figures shown here for the Co Revised 2000 and 2001 MMBTU (14,872,422 and 13,077,438, respectively) are implied by the dollar adjustments proposed by the Company (rather round numbers of \$9,700,000

Docket 99-0127. Analogous with in-field transfers (discussed in the previous subsection), including these storage withdrawals in the Docket 99-0127 computations raised the Commodity Adjustment higher than it would otherwise have been. Then, after 99-0127 was over, perhaps to boost the benchmark, again, the Company removed further NGPL withdrawals from the on-going storage credit adjustment.

Second, even though the released storage was no longer under the direct control of Nicor Gas, there were still expected benefits associated with the use of the service that existed prior to and during the tenure of the PBR program.³⁴ For purposes of evaluating the Company's performance, there was no reason to believe that Nicor Gas supply portfolio should not continue to reap those expected benefits, even after it released the NGPL storage capacity to a third party. Indeed, since IMD was expected by Nicor to do a better job managing storage, there should have been an expectation of even larger benefits. Hence, the benchmark should have continued to reflect withdrawals from the released NGPL storage capacity.

Q. Why should we expect Nicor Gas to continue to reap the benefits of storage capacity that is released to a third party?

A. I will try to explain this with an analogy. Suppose you owned and operated a store that made a profit of \$1 million each and every year for the last 10 years and was expected to continue to reap a profit of \$1 million each year into the future. Suppose you

and negative \$2,800,000) divided by the respective SCA rates. On the other hand, Staff's computed value for 2002 is within 0.0003% of the Company's computation of 10,610,645 MMBTU.

³⁴ As Company attorney, Steve Mattson, explained during oral arguments in Docket 99-0127, "It stands to reason that you better your prices as a result of having storage because of seasonal price differentials, and the company felt that it was only right to give the customers the benefit of that differential." (Transcripts from November 2, 1999 special open meeting of Commission to consider oral arguments in Docket 99-0127, p. 71, lines 10-15)

1191 found somebody with even more skill than you in operating this store. This person can
1192 make a profit of \$1.1 million each year. So you negotiate a deal to sell the store.
1193 However, rather than sell the store for cash, you accept an installment plan. What is the
1194 minimum that you will accept each year? Is it \$0? Of course not. The answer, of
1195 course, is something in the realm of \$1 million to \$1.1 million. Similarly, there is no
1196 reason for us to expect that Nicor Gas would simply give away its control of NGPL
1197 storage capacity for no consideration. Rather, it should demand something in return, like
1198 its value, either on an expected or after-the-fact basis.

1199 Of course, the value of storage is not a constant \$1 million every year, but
1200 fluctuates.³⁵ That is why the storage credit adjustment was specifically designed to float
1201 with yearly changes in the differential between withdrawal and injection season market
1202 prices. Some years the value can even be negative, as we saw in 2000 and 2002, but at
1203 the end of 1999, it was reasonable to expect that the value would be positive.³⁶ Indeed,
1204 one of the Company's strategies was to try to lock in a profit associated with the expected
1205 winter-summer differential in prices (as would be reflected in the natural gas futures
1206 market). Implementation of this strategy involved selling winter gas short while taking a
1207 long position on summer gas. Ironically, while this reduced the Company's risk, it
1208 increased ratepayers' risk.

³⁵ So the store analogy could be modified to allow an expected range of profit between negative \$100,000 and positive \$2,100,000, and a mean of \$1,000,000.

³⁶ As noted in Table 10, at the end of December 1999, the SCA rate implied by futures prices was \$0.043 per MMBTU. Also, in Docket 99-0127, when the benchmark was created, the after-the-fact value of the Company's entire storage portfolio within the five-year period, 1994 to 1998, was computed to have ranged between \$9 million and \$116 million (all positive). The Company did not want to take the risk of such large fluctuations. So instead of asking for a fixed adjustment around \$40 to \$50 million, it sought and received from the Commission permission to adopt the fluctuating storage credit adjustment.

1209 **Q. How did the Company's strategy for locking in a profit on winter-summer price**
1210 **differentials reduce its own risk but increase the risk faced by ratepayers?**

1211 A. It is a fairly complicated matter, but I will try to outline the mechanics of the
1212 situation. As noted above, the strategy was to sell winter gas short, while taking a long
1213 position on summer gas. With such a position, consider what would happen if winter
1214 spot prices rose above the prices of the previously-established short position in winter
1215 gas. In that case, the PGA would experience a financial loss when closing out the short
1216 position. However, the market index component of the PBR benchmark would also rise
1217 by the same amount. Hence, PBR "savings" (and the Company's share of savings) would
1218 be unaffected.

1219 Ratepayers' risk, on the other hand, would increase, since they would pay for
1220 such financial losses through the PGA, at a time when prices already would be
1221 unexpectedly high. In fact, by removing the related NGPL storage withdrawal volumes
1222 from the SCA, the added risk to ratepayers was exacerbated even further by the
1223 Company's strategy. Prior to the removal of such volumes, the SCA would increase with
1224 any increase in the actual winter-summer price differential. Thus, the change in the
1225 market index component of the benchmark would be offset by the change in the SCA
1226 component, leaving the total benchmark unchanged. However, by removing the NGPL
1227 storage withdrawal volumes from the SCA computation, ratepayers would not experience
1228 the offsetting effect of the SCA.

1229 **Q. Do you recommend any disallowance for the Company increasing ratepayers' risk**
1230 **with this strategy?**

1231 A. No. However, for the independent reasons noted earlier, I do recommend that the
1232 withdrawals from released NGPL capacity be added back into the computation of the
1233 SCA component of the benchmark. This essentially requires the Company and
1234 ratepayers to each absorb one-half the risk brought on by the Company's strategy. In my
1235 opinion, such an equal allocation of risk and reward was a principal expectation
1236 embedded in the Commission-approved 50-50 sharing formula.

1237 **Q. Does your recommendation affect the gas cost and inventory accounting associated**
1238 **with the above-cited storage transactions?**

1239 A. No. I recognize that there may be legitimate accounting purposes for treating
1240 some of the NGPL storage transactions as purchases rather than storage injections and
1241 withdrawals (this is a technical accounting issue). My recommendations apply only to
1242 the computation of the benchmark.

1243 **Q. Have you calculated the amount of third-party withdrawals from released NGPL**
1244 **capacity?**

1245 A. Yes. Unfortunately, the Company claims that it was not able to provide to Staff
1246 the actual level of monthly withdrawals and injections of capacity that was released to
1247 third parties. Instead, the Company has only been able to provide net monthly
1248 withdrawals minus injections. Thus, Staff has resorted to the following estimation
1249 procedure. Using data from 1995 through 1998 (pre-PBR), the Company's average
1250 withdrawals from NGPL storage were 26,663,465 MMBTU per year. This number is
1251 compared against the Company's restated withdrawals in the PBR years to estimate the
1252 withdrawals of third parties using this storage in 2000 through 2002.

Q. What is the effect of adding back in to the benchmark the NGPL storage withdrawals associated with capacity that the Company released to third parties?

A. For the two years in which the storage credit adjustment rate was inverted (displaying a negative winter-summer price differential), adding the estimated third-party withdrawals increases the benchmark by \$919,842 (2000) and \$3,282,166 (2002). However, for the year in which the winter-summer price differential was positive, adding back the estimated third-party withdrawals reduces the benchmark by \$32,537,913 (2001). The combined effect of these adjustments is a net decrease in the 2000-2002 PBR benchmarks of \$28,335,907, and a net refund of \$14,167,954 (half the benchmark decrease).

E. Affiliate Transactions

Q. Can you describe the transaction in which Nicor Gas provided a discount on gas sold to its affiliate, Nicor Enerchange, in January 2000?

Q. On January 28, 2000, Nicor Gas sold 2.4 million MMBTU of gas to its affiliate, NICOR Enerchange. The price was set at \$2.45 per MMBTU. The Gas Daily rate on that day was \$2.73. Hence, in relation to the Gas Daily rate, the \$2.45 sale price amounted to about a 10% discount of 28 cents per MMBtu (almost \$700 thousand). However, the transaction was for future delivery in September and October. The Henry Hub futures price for September and October were \$2.535 and \$2.55, respectively. The basis differential between Chicago and the Henry Hub on this day was about 7 cents per MMBTU. Hence, judging by the prevailing futures price plus basis, the \$2.45 sale price amounted to a discount of about 16 cents per MMBtu (almost \$400 thousand). Since prompt payment was made to Nicor, well before operational delivery was required to

1276 take place, the actual discount was effectively about one-third this amount (assuming a
1277 7% interest rate). Thus, a reasonable assessment of the actual discount was that it was
1278 about 2% of the value of the gas at the time of the transaction.

1279 **Q. What else occurred on this day?**

1280 A. Apparently concerned with the “impression of impropriety” that the Enerchange
1281 deal might create, the Company entered into two other transactions with unaffiliated
1282 parties for a total of 900,000 MMBTU at the same price and roughly the same future
1283 delivery terms.³⁷

1284 **Q. Was there any need for the Company to enter into these transactions?**

A. The Lassar Report’ discussion of this issue leaves the impression that the Company had “a pressing need to eliminate the overflow of gas it experienced in January 2000.”³⁸ However, this would largely be a false impression. Quite the contrary, for operational reasons (as part of its plan to meet winter demand), the Company wished to physically maintain possession of the gas through the remainder of the winter.³⁹ Hence, the deal was for delivery several months into the future. The Company’s “pressing need to eliminate the overflow of gas it experienced in January 2000” was merely a perceived

³⁷ Lassar Report, p. 69.

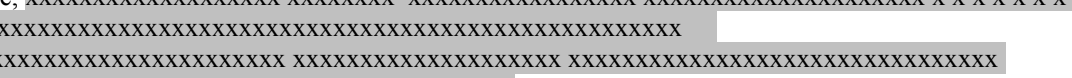
³⁸ Lassar Report, p. 70.

[illegible]

1292 need to increase accounting “withdrawals” because Nicor was behind schedule vis-à-vis
1293 its plan for beating the storage credit adjustment component of the PBR benchmark.⁴⁰
1294 Despite the Company’s claims to the Commission in Docket 99-0127 -- that storage
1295 withdrawals were a function of weather and that the Company would not and could not
1296 manipulate storage withdrawals⁴¹ -- here in the very first month of the program the
1297 Company was already busy manipulating withdrawals from an accounting standpoint.

1298 **Q. How does Staff value the harm to ratepayers of these transactions?**

1299 A. While the discount at the time of the transactions was relatively small, there was
1300 still no legitimate reason for the Company to enter into these transactions. Furthermore,
1301 unless Nicor Gas took steps to lock in a buy price for those future delivery months, its
1302 commitment for future delivery placed ratepayers at risk for upward fluctuations in gas
1303 prices. Such an upward fluctuation indeed occurred, so that when the Company was
1304 required to make delivery, the opportunity cost was linked to the spot market prices
1305 prevailing in July, September and October. That is, the July, September and October
1306 prices are what it would have cost the Company to replace the gas sold to Enerchange or
1307 otherwise what Nicor would have foregone in additional spot market sales. Without the
1308 unnecessary transactions, designed to somewhat enrich an affiliate and designed around

40 For instance, 

the manipulation of storage withdrawals, the Company would never have incurred such an increase in gas costs.

Therefore, I recommend that the Commission deny recovery of the excess of the replacement cost of the gas at the time of delivery over the revenues received. As shown in Table 12, this leads to an imputed decrease in gas costs of \$8,517,172, of which the Company retains half due to the PBR sharing mechanism. The net effect of making this adjustment to 2000 PGA costs would be a refund to customers of \$4,258,586.

Table 12. Effect of the Jan 2000 Sale to Enerchange

Month	Volumes		Prices				Computation of Cost Decrease (Increase) based on Monthly Spot Index Prices at time of Delivery		
	Volumes sold to Enerchange	Additional Volumes sold to other parties at same price	Sale Price on Jan 28	Monthly Spot Index Prices	Henry Hub Futures prices on Jan 28	Price differential between Chicago and Henry Hub	Revenues (Incremental Costs) associated with sale to Enerchange	Revenues (Incremental Costs) associated with sale to Other Parties	Total Revenues (incremental Costs)
Jan-00	2,400,000	900,000	2.45	2.438			5,880,000	2,205,000	8,085,000
Feb-00				2.674					
Mar-00				2.714					
Apr-00				2.976					
May-00				3.295					
Jun-00				4.450					
Jul-00		(300,000)		4.309	2.505	0.07		(1,292,595)	(1,292,595)
Aug-00				4.095					
Sep-00	(900,000)	(600,000)		4.858	2.535	0.07	(4,372,010)	(2,914,673)	(7,286,683)
Oct-00	(1,500,000)			5.349	2.55	0.07	(8,022,894)		(8,022,894)
Nov-00				4.950					
Dec-00				7.385					
Total							(6,514,903)	(2,002,269)	(8,517,172)

F. NICOR's Discount On a Gas Sale to Aquila In Exchange For a Discount On a Non-PGA Purchase Of Weather Insurance

Q. Can you describe the transaction in which Nicor Gas received a discount on a non-PGA purchase of weather insurance in exchange for providing a vendor (Aquila) with a discount on a sale of gas?

A. Staff first became aware of this transaction when it read Chapter V of the October 28, 2002 Lassar Report (pp. 40-48, or NIC 049841-049849). In that report, it was alleged

⁴¹ Gilmore Rebuttal, p. 6.

that Nicor Gas provided a discount to Aquila of \$2 million on a sale of gas in exchange for a \$2 million discount on the premiums for weather insurance for calendar year 2001. More or less confirming the Lassar Report, Staff has determined through review of Company records that 3 million MMBTU were sold to Aquila in the fall of 2000 for future delivery in March and April 2001. Furthermore, the price of the gas sold seemed to be based on the then-current futures prices for those two future months plus basis differentials, less a discount of about \$2.2 million.

Moreover, according to the Lassar report, by the time that Nicor had to make delivery, the market price of gas had risen, and the apparent loss had “ballooned to over \$6 million.”⁴² Again, based on review of Company records, Staff has confirmed that the discounted sale of gas led to an actual loss to Nicor of over \$6.1 million.

1336 The discounted cost of the weather insurance and any benefits from the insurance
1337 were not to be included in the PGA, but were to inure entirely to the benefit of the
1338 Company. Because the 2001 temperatures were relatively mild, Nicor Gas received a
1339 benefit of \$xxxxxxx on the weather insurance.⁴³ This financial gain was not included
1340 as an offset to PGA costs (and I am not suggesting that it should have been).

1341 **Q. How does the Lassar Report recommend that the Company address the issue?**

1342 A. The Lassar Report concludes that:

⁴² This \$6 million showed up as a sure loss in the Company's internal "Buckets Reports" throughout much of 2001. See, for example, KPMG 024439-024442 and 024444-024448.

⁴³ The Company's out-of-pocket cost of the weather insurance was a net premium of \$xxxxxxx. Thus, based on the mild temperatures that existed, the Company netted a xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx
xxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx. However, the true cost of the insurance also included an additional \$2 million (the premium discount traded for the gas sale discount). Hence, the true insurance premium was more like \$xxxxxxxx.

The Aquila transaction was clearly improper. However, the harm to ratepayers depends upon whether the ratepayers will be permitted to retain the LIFO benefit. If the LIFO benefit to the ratepayer is reversed, then the ratepayer was harmed by the Aquila transaction in the amount of \$3.1 million [half the ultimate loss of just over \$6.1 million]. If the ratepayer is permitted to retain the LIFO benefit, then arguably the ratepayer was not harmed by the Aquila transaction. (p. 48)

Notably, the LIFO benefit for 2001 was reversed by the Company's accounting restatement. Hence, as long as that restatement stands, the final sentence in the above quote is moot, and the Lassar Report would be left recommending a \$3.1 million refund associated with the Aquila transaction. Nevertheless, I will return to that final sentence later in this section.

Q. How does the Company address the weather insurance issue in its re-opening testimony?

A. Oddly enough, the Company deviates from the recommendation in the Lassar Report, even though the Company previously indicated that it accepted the Lassar Report's conclusions.⁴⁴ Instead of a cost adjustment in excess of \$6.1 million and a refund of about \$3.1 million, the Company now proposes a cost adjustment of \$2 million, resulting in a refund to customers of only \$1 million.⁴⁵ The Company's current adjustment is based on the original \$2 million discount to Aquila (where the price of the

⁴⁴ Company's January 24, 2003 response to Citizen's Utility Board data request CUB 10.03. Also see the Company's 8-K report to the SEC, filed on 10/31/2002, which states, in part, "The Special Committee hereby recommends that the Board of Directors direct the Company to adopt the recommendations set forth in Sidley's Report. The Board should direct the Company to make appropriate adjustments to properly account for, and fully address the adverse consequences to ratepayers of, the following issues: (1) the 1999 sale of the Company's DSS storage; (2) the improperly-accounted for DSS transactions in 2000 and 2001; (3) carrying costs improperly included in the Company's PBR filing; (4) the metering error that occurred in 2001; **(4) the purchase of weather insurance from Aquila for fiscal 2001**; (5) the inconsistent recording of in-field transfers during 2000 and 2001; and (6) the improper accounting for storage prefills." (Exhibit EX-99.1, p. 1, emphasis added)

⁴⁵ See Barrett Direct Testimony, p. 24, and his Attachment MEB-4.

actual sale to Aquila is compared to the market price, at the time of the sale, of the March and April 2001 futures contracts plus basis). Staff does not believe that this adequately measures the harm to ratepayers from the transaction.

Q. How does Staff compute the harm to ratepayers of this transaction?

A. Because of this transaction, Staff estimates that gas costs increased by approximately \$6,115,050 less the half absorbed by Nicor Gas due to the PBR sharing mechanism. Hence, consistent with the Lassar Report's recommendation, ratepayers should receive a net refund of \$3,057,525. As shown in the table below, this figure is based on the difference in the monthly index prices prevailing at the time of delivery and the contract price for the sale to Aquila.

Table 13. Effect on Ratepayers of the Weather Insurance for Gas Discount Deal

	Mar-01	Apr-01	TOTAL	One-Half the TOTAL
Aquila Contract Volumes (MMBTU)	1,500,000	1,500,000	3,000,000	
Aquila Contract Price	\$3.5075	\$3.2050		
Total Revenues	\$5,261,250	\$4,807,500	\$10,068,750	
Monthly Price Index	\$5.2906	\$5.4986		
Monthly Price Index minus Aquila Contract Price	\$1.7831	\$2.2936		
Monthly Price Index minus Aquila Contract Price times Aquila Contract Volumes	\$2,674,650	\$3,440,400	\$6,115,050	\$3,057,525

Q. Does your recommended refund imply that Staff is opposed to the Company purchasing weather insurance for shareholders?

A. No. The Staff does not necessarily object to the Company purchasing weather insurance. However, the Commission has a rule relating to what can and cannot be included in the PGA. The Company defied that rule. Based on the gas futures prices

prevailing at the time of the transaction, the Company could have *expected* the PGA to improperly include about \$2.2 million for this weather insurance (the discount to Aquila). Furthermore, because the gas sale to Aquila was for future delivery and unhedged, the transaction ended up increasing PGA costs by \$6,115,050. Taking half of this, ratepayers paid an additional \$3,057,525 through the PGA, indirectly for the Company's weather insurance.

Q. Earlier, you quoted the Lassar Report where it states,

If the ratepayer is permitted to retain the LIFO benefit, then arguably the ratepayer was not harmed by the Aquila transaction. (p. 48)

Do you concur with this statement?

A. No. This notion seems to have originated with certain executives within the Company who were trying to rationalize the deal. For instance, in a deposition given to the Staff, Executive Vice President, Kathy Halloran, argued that

[T]his would utilize LIFO layers that were much lower priced, and by selling some quantities of that gas would create a gain that would be shared equally between the ratepayers and the Company.⁴⁶

In my opinion, though, annual net withdrawals from old LIFO layers have absolutely nothing to do with offering discounts on gas deals. For one thing, accessing the old LIFO layers (through the prefill deals and the original prefill accounting) was completely independent of any single gas sale to Aquila or any other party. A discounted gas sale to Aquila was going to increase the PGA no matter what happened with LIFO.

Frankly, with respect to the Aquila deal, it is very hard for me to imagine how Ms. Halloran and other high-level executives could have taken much ethical solace in a

[illegible]

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1464 Despite all of these contrary opinions, the Company made the decision at the highest
1465 levels, to barter a gas discount in exchange for a discount on weather insurance.

1466 Q. Mr. Barrett asserts it is “legitimate ... for a utility to enter into a barter whereby it
1467 pays for things such as weather hedges with gas.” Do you agree?

1468 A. No, because as the Lassar Report makes clear, the effect of such barter is to
1469 essentially include non-gas costs in the PGA. Mr. Barrett’s approach, taken to its logical

⁵⁵ xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx.

conclusion, would nullify the provisions of both the Public Utility Act and the Commission's rules pertaining to PGAs. The practical effect of Mr. Barrett's position is that utilities could pick and choose which base rate costs to virtually convert into "gas costs" – picking and choosing only those base rate costs that are rising. It should come as no surprise that Nicor did not barter away paying more for some base-rate expenditure in exchange for receiving a premium on a gas sale. After all, that would benefit ratepayers rather than the Company.

To conclude, Nicor should know that Staff considers the Aquila deal to be among the most unethical and reprehensible acts uncovered in this investigation. If it were clearly authorized by law, Staff would be seeking to impose significant penalties on the Company and the specific individuals responsible for this deal. Instead, Staff is only seeking the return of the actual cost increases suffered by ratepayers.

G. Improper Inclusion in the PGA of Carrying Charges Associated with Managed Storage Deals Using Released NGPL Storage

Q. How did the Company include carrying charges associated with managed storage deals in the PGA?

A. Instead of buying gas during the injection season, leaving it in storage (incurring carrying costs) and withdrawing it during the withdrawal season, the Company released capacity to third parties and allowed them to perform all of the above steps. When the Company bought the gas during the withdrawal season, it paid explicit or implicit carrying charges embedded in the price.

Q. What does Staff propose to do about these carrying charges?

1492 A. As noted above, it is common Commission practice to include a return on the cost
1493 of gas in storage inventory in base rates. To avoid double-recovery, the Commission's
1494 PGA rules prohibit the inclusion and recovery of carrying charges on gas in storage.
1495 However, with the released storage capacity, the Company either explicitly or implicitly
1496 paid carrying charges to vendors for gas delivered to the Company. These explicit and
1497 implicit carrying charges were included in the ultimate price paid by the Company,
1498 included in the PGA, and recovered from ratepayers. Thus, Staff recommends
1499 adjustments to remove these carrying charges from the PGA for the years 1999 through
1500 2002.

1501 **Q. Have you computed the carrying charges associated with managed storage deals**
1502 **using released NGPL storage capacity that were included in the PGA during the**
1503 **years in question?**

1504 A. Yes. I computed the Company's average monthly balance of NGPL storage gas
1505 during the period between January 1995 and December 1998 and compared that to the
1506 monthly balances during each of the years 1999 through 2002. I applied those
1507 differences to an interest rate of 7%, resulting in the following imputed carrying charge:
1508 \$1,286,931 (1999), \$3,562,686 (2000), \$4,950,996 (2001), and \$2,879,774 (2002). I
1509 recommend that the entire amount in 1999 be refunded to customers and half the amount
1510 in years 2000 through 2002, resulting in a total refund of \$6,983,659.

1511 **H. Error in the Reporting of Deliveries of PGA Gas to Customers**

1512 **Q. Please explain the error in the reporting of deliveries of PGA gas to customers.**

1513 A. Apparently, in 2001, there was a metering error that led to a misreporting of gas
1514 delivered to customers. Efforts appear to have been made to correct this error. However,

those efforts were not complete, resulting in an excess volume of gas being included in the market index and commodity adjustment component of the benchmark. Staff computes the effect of the error to be a \$2,317,531 overstatement of the benchmark, of which half, \$1,158,765, was absorbed by ratepayers due to the PBR program's 50-50 sharing mechanism.

After this error in the benchmark was raised by the whistle-blower fax, the Company alleged in a Staff data request that it was planning to make an adjustment to correct the admitted error. Ultimately, this appears to have been done. Staff accepts the Company's meter error adjustment to the original 2001 PBR savings computation and Staff adopts this within its own computations.

I. Exclusion of Hub Revenues from the PGA

Q. What is the Chicago Hub?

A. The Chicago Hub is a name used to identify various services offered by Nicor that are not governed by ICC tariffs, but that rely on the Company's access to various natural gas storage and transportation assets in northern Illinois. An example of a Chicago Hub service is a gas loan (or reverse parking), whereby Nicor loans a quantity of gas to a gas marketer, who brings the same quantity of gas back to Nicor at a later date and also pays Nicor a monetary fee.

Q. Are the revenues from such Chicago Hub services included in Nicor's PGA?

A. In seeming compliance with the Commission order in ICC Docket 95-0219 (the Company's last rate case), revenues from some of the Hub storage services are flowed

1536 through the PGA,⁵⁶ while revenues from other Hub services are not flowed through the
1537 PGA.⁵⁷ However, more careful examination of this latter group of transactions reveals
1538 that many of them are not the type of hub services that the Commission previously
1539 authorized the Company to exclude from the PGA. In contrast, they are subject to
1540 Section 525.40(d) of the Commission's PGA rule, which requires, in part, that
1541 "[r]ecoverable gas costs shall be offset by the revenues derived from transactions at rates
1542 that are not subject to the Gas Charge(s) if any of the associated costs are recoverable gas
1543 costs as prescribed by subsection (a) of this Section."⁵⁸ Hence, revenues from those
1544 transactions should have been included in the PGA as an offset to gas costs.

⁵⁶ With respect to "off-system storage revenues," the Commission directed the Company "to remove the entire \$1,164,000 forecast of revenues from the rate case and ... to reflect its actual off-system storage revenues in its PGA calculation, net of related costs not otherwise [*40] recovered and properly shown in the reconciliation proceedings, in accordance with 83 Ill. Adm. Code 525.40(d), beginning with its first PGA calculation filed subsequent to its compliance rate filing in this case." (Docket 95-0219, Order, April 3, 1996, [1996 ILL. PUC LEXIS 204, 39-40](#)). In review of the Company's response to Staff data request ICC 7.05 (10/18/2002), for contracts covering the period between June 1, 1998 and March 31, 2003, there appears to have been about \$1.5-2.1 million per year of hub revenue that flowed through the PGA as an offset to gas costs.

⁵⁷ The Commission concluded that "On March 13, 1996, in Docket 93-0320, [*35] the Commission issued an Order denying the Company's proposed [50-50] sharing of Hub revenues and requiring the treatment of all Hub revenues above-the-line for ratemaking purposes. The Commission determines that, by treating Hub revenues totally above-the-line an additional adjustment of \$ 471,500 is adopted for a total adjustment to revenues of \$ 627,500." (Docket 95-0219, Order, April 3, 1996, [1996 ILL. PUC LEXIS 204, 35](#)). This implies the total revenues included above-the-line in this rate case were 2x\$471,500 or \$943,000. In review of the Company's response to Staff data request ICC 7.05 (10/18/2002) in the instant docket, for contracts covering the period between June 1, 1998 and March 31, 2003, there appears to have been at least \$3.2-3.8 million per year of hub revenue that did not flow through the PGA.

⁵⁸ In the Commission's Order adopting this rule, it referred to the types of transactions covered by §525.40(d) as "off-system transactions" and noted that they may include capacity releases, sales for resale, buy/sell transactions and exchanges. The Commission concluded:

With respect to off-system transactions, the Commission finds the Staff's proposal appropriate. The utilities' proposals for revenue sharing, i.e., partial rather than full offset to recoverable gas costs, are inappropriate in the application of the Purchased Gas Adjustment as a means of encouraging utilities to maximize the number of prudent off-system transactions in which they engage. In fact, Illinois utilities have [*17] been engaging in such transactions, such as capacity release, without revenue sharing. The Commission is concerned that revenue sharing would create incentives for utilities to subsidize off-system transactions with on-system transactions and could therefore result in PGA gas charge increases. The Commission concludes that utilities already have incentives to engage in prudent off-system transactions which result in PGA decreases. Any additional incentives that a utility wishes to suggest should be handled

1545 **Q. How did you determine that many of the transactions that Nicor excluded from the**
1546 **PGA are not the type of hub services that the Commission previously authorized the**
1547 **Company to exclude from the PGA?**

1548 A. In the Docket 95-0219 order cited above, the Commission references and adopts
1549 the primary conclusion from its earlier order in Docket 93-0320, which denied the
1550 Company's proposed 50-50 above and below-the-line accounting treatment for hub
1551 revenues and required all those revenues to be recorded above-the-line as an offset to
1552 recoverable base-rate gas costs (see footnote 57). Thus, the Commission implied that
1553 these hub services should not be included as an offset to gas costs in the PGA. However,
1554 at that time, the Commission had a completely different picture of "hub services" than
1555 what the Company actually provided during the 1999 through 2002 period currently
1556 under review. In Docket 93-0320, Nicor described the Hub's services as follows:

1557 *The Hub facilitates the movement of gas between and among interstate*
1558 *pipelines attached to the Company's system. The Hub also permits storage*
1559 *of gas for short periods of time before redelivery to an interstate pipeline.*
1560 *The Hub also will accommodate gas title transfers. The Company provides*
1561 *these services pursuant to authorization by the Federal Energy Regulatory*
1562 *Commission ("FERC") and subject to operational constraints such that*
1563 *the Company's utility customers are not and will not be adversely*
1564 *impacted. (1996 Ill. PUC LEXIS 151, 2 (Ill. PUC, 1996))*

1565 After reviewing Company records on hub transactions, it appears as if many of those
1566 transactions do not fit within the above description. In particular, none of the multi-cycle
1567 gas loans appear to fit within the type of transactions that were described to the
1568 Commission in Docket 93-0320. Each of the multi-cycle gas loans appear to have a term
1569 of either eleven or twelve months, from the injection season through the withdrawal

in a Section 9-244 proceeding and should not be part of a general rule. (ICC Docket 94-0403, Order,

season of the following calendar year, and they are all paired with a long-term storage agreement, as well. These transactions appear to be completely different than the ones considered by the Commission in Docket 93-0320, and clearly fit within the meaning of Section 525.40(d). Hence, I recommend that the Commission order all revenues from these transactions to be included in the PGA as an offset to PGA costs. Prorating the revenues collected by the Company by month, this constitutes a cost reduction adjustment of approximately \$10.3 million between the beginning of 1999 and the end of 2002, with about \$1.9 million of that total applicable to 1999, and the remaining \$8.4 of that total applicable to the PBR period 2000-2002. After taking into account the effect of the PBR's 50-50 sharing mechanism, the refund due to ratepayers would be \$6.1 million (i.e., $0.5 \times \$8.4 \text{ million} + \1.9 million).

J. Accounting Adjustments

Q. Can you summarize the Company's accounting restatement that was presented in its testimony on reopening?

A. The restatement had effects on both the storage credit adjustment component of the benchmark and on costs. The changes with respect to the storage credit adjustment component of the benchmark lead to a refund of about \$8 and have already been discussed in Section D. The accounting restatement's more direct impact on gas costs leads to a surcharge of approximately \$15 million, due primarily to less of the low-cost LIFO layer gas being withdrawn from storage. Based on Staff Accounting's review, Staff is not disputing the restatement.

K. Staff Witness Maple's Adjustments

Q. According to Staff witness Maple, there should be additional refunds of \$8,537,685 due to adjustments to the benchmark in 2000 through 2002, as well as to gas costs in 1999. Have you accounted for these proposed adjustments?

A. Yes. Mr. Maple's adjustments are included within my summary Tables 2, 3, and 4 (pp. 15-16), and are included in the computation of Factor O interest in Table 15 (p. 86).

L. Adjustment Related to the Two-percent of Storage Withdrawals Assumed by Nicor to be Lost

Q. According to Staff witness Knepler, there should be additional refunds associated with lost storage gas, the cost of which the Company has been including in the PGA. Have you assisted Mr. Knepler in computing the size of this adjustment?

A. Yes. Based on discussions with Mr. Knepler, it is my understanding that the Company has been accounting for a portion of its lost gas by adding two percent to gross withdrawals from storage. After transportation customers pay for their share of lost storage gas, the Company has been recovering the remaining cost through the PGA. However, according to Mr. Knepler, the Commission's PGA rule does not permit utilities to recover the cost of lost storage gas through the PGA. Rather, the expense of lost storage gas is considered a base-rate item. In consultation with Mr. Knepler, I have computed the quantity of the lost storage gas recovered through the PGA in 1999 through 2002, by taking 2% of aquifer withdrawals and subtracting 2% of withdrawals by transportation customers. In net withdrawal years (1999, 2000, and 2002), I valued the lost gas at the original cost of the withdrawn storage inventory, using the LIFO convention. In the net injection year (2001), I valued the lost gas at the original cost of

the new 2001 LIFO layer, as computed by the Company. Removing from the PGA the computed cost of lost storage gas leads to an additional refund of \$25,983,326. The results of these computations are summarized in Table 14 below. The details of the computations are shown in **Attachment 5**.

Table 14. Adjustment Related to the Two-percent of Storage Withdrawals Assumed by Nicor to be Lost

	Therms					\$
	Aquifer WD Before Infield Transfers	Customer Owned Gas WD	2% of Customer owned Gas WD	Company portion of Aquifer WD	2% of Company owned gas WD from Aquifers	Original LIFO cost of the 2% of Company owned gas WD from
	A	B	C=0.02*B	D=A-B-C	E=0.02*(D/1.02)	see Attachment 5
1999	(1,356,814,460)	(299,358,650)	(5,987,173)	(1,051,468,637)	(20,617,032)	(\$5,928,740)
2000	(1,391,812,960)	(453,879,240)	(9,077,585)	(928,856,135)	(18,212,865)	(\$5,885,468)
2001	(1,013,945,050)	(498,781,330)	(9,975,627)	(505,188,093)	(9,905,649)	(\$5,085,688)
2002	(1,524,526,540)	(610,021,100)	(12,200,422)	(902,305,018)	(17,692,255)	(\$9,083,432)
Total	(5,287,099,010)	(1,862,040,320)	(37,240,806)	(3,387,817,884)	(66,427,802)	(\$25,983,326)
Avg	(1,321,774,753)	(465,510,080)	(9,310,202)	(846,954,471)	(16,606,950)	(\$6,495,832)

Q. How does this adjustment to PGA costs affect PBR savings?

A. Since, according to Mr. Knepler, the Company should have been excluding the cost of lost storage gas from the PGA all along, the PBR benchmark should have excluded such costs all along, as well. Hence, for purposes of computing savings, I have left out the reduction in 2000 through 2002 costs arising from the \$25,983,326 adjustment, discussed above.

V. Miscellaneous Issues

A. Net Interest on Factor O Refunds/Surcharges

Q. Nicor witness Moretti computes interest of \$780,374 owed by ratepayers to Nicor through the operation of the PGA's Factor O. Mr. Moretti's computations are shown on the Company's Attachment TMM-3. Do you agree with Mr. Moretti's computations?

1634 A. No. As shown in Table 15, below, my alternative computation of Factor O
1635 interest results in a payment to ratepayers of \$4,450,799 . The difference between my
1636 proposed interest payment **to** ratepayers of \$4,450,799 and the Company's proposed
1637 payment **by** ratepayers of \$780,374 is due to two factors. First, Mr. Moretti's interest
1638 calculation is based on the Company's proposed adjustments to the PGA for 1999
1639 through 2002, while my interest calculation is based on the Staff's significantly different
1640 adjustments, discussed in Section IV of my testimony. In addition, there is an error in the
1641 method used by Mr. Moretti to make his interest computations. With the Company's
1642 proposed adjustments, Mr. Moretti's methodological error has a very minor impact,
1643 increasing the interest payment by only \$785 (less than 1%). However, with a different
1644 set of PGA adjustments, the methodological error can be more significant (I will explain
1645 why in the next Q&A). For example, with the Staff's proposed PGA adjustments, Mr.
1646 Moretti's methodological error would reduce the interest payment to ratepayers by
1647 \$2,146,259 (48%).

1648 **Q. What is wrong with Mr. Moretti's method of interest computation?**

1649 A. It appears that Mr. Moretti attempted to compute compound interest for each year
1650 between 2001 through 2003 for PGA adjustments applicable to 1999 through 2001.
1651 However, he did this by multiplying together the interest rates from the adjustment year
1652 through the year in which interest was being calculated and then multiplied that product
1653 by the adjustment. For example, for the 1999 Requested Factor O interest computations,
1654 he computed interest for 2003 as the 2000 interest rate times the 2001 interest rate times
1655 the 2002 interest rate times the 2003 interest rate times the \$13 million adjustment
1656 proposed by the Company for the 1999 PGA year. This method grossly understates the

1657 actual compound interest, in fact rendering it significantly less than simple (non-
1658 compound) interest. The gross understatement becomes quite obvious when one looks at
1659 the last column of the interest calculation for the 1999 Requested Factor O, showing \$14
1660 as the 2003 interest on the original 1999 adjustment of \$13 million. That is an implied
1661 interest payment of an absurd 0.000099 percent.

1662 In contrast, the correct method of computing the interest that accrued in 2003
1663 would be to multiply the 2003 interest rate by the sum of the original adjustment of \$13
1664 million and the interest payments that previously accrued from 2000 through 2002. Thus,
1665 as shown in Table 15, the correct method would have resulted in \$235,293 as the 2003
1666 interest on the Company's original 1999 adjustment (implying a compound interest rate
1667 of 1.7 percent).

1668 By pure coincidence, the Company's proposed adjustments for 1999 through
1669 2002 happened to go from negative to positive and back to negative in a certain way that
1670 practically negated the importance of the Company's compound interest calculations
1671 (i.e., they almost completely netted out to zero). However, as previously mentioned, the
1672 methodological error can be much more significant when other adjustments are involved,
1673 such as those proposed by Staff.

**Table 15. Company and Staff Calculations of
Factor O Interest Owed to Company (Ratepayers)**

	Year	2000	2001	2002	2003	
	Interest Rate	5.5%	6.0%	2.0%	1.5%	Total
Company's Computation Using Company's Prioposed Adjustments and Incorrect Methodology						
Year of Adjustments	Adjustments					
1999	(\$13,751,764)	(756,347)	(45,381)	(908)	(14)	(802,649)
2000	\$36,017,779		2,161,067	43,221	648	2,204,936
2001	\$4,161,375			83,228	1,248	84,476
2002	(\$47,092,620)				(706,389)	(706,389)
	Total	(\$756,347)	\$2,115,686	\$125,541	(\$704,506)	\$780,374
Calculation Using Company's Proposed Adjustments but the Correct Methodology						
Year of Adjustments	Adjustments					
1999	(\$13,751,764)	(756,347)	(870,487)	(307,572)	(235,293)	(2,169,698)
2000	\$36,017,779		2,161,067	763,577	584,136	3,508,780
2001	\$4,161,375			83,228	63,669	146,897
2002	(\$47,092,620)				(706,389)	(706,389)
	Total	(\$756,347)	\$1,290,580	\$539,232	(\$293,876)	\$779,589
Calculation based on Staff's Proposed Adjustments, but using Company's Incorrect Methodology						
Year of Adjustments	Adjustments					
1999	(\$24,445,418)	(1,344,498)	(80,670)	(1,613)	(24)	(1,426,805)
2000	\$13,357,526		801,452	16,029	240	817,721
2001	(\$13,313,806)			(266,276)	(3,994)	(270,270)
2002	(\$95,012,356)				(1,425,185)	(1,425,185)
	Total	(\$1,344,498)	\$720,782	(\$251,860)	(\$1,428,963)	(\$2,304,540)
Staff's Interest Calculation based on Staff's Proposed Adjustments and the Correct Methodology						
Year of Adjustments	Adjustments					
1999	(\$24,445,418)	(1,344,498)	(1,547,395)	(546,746)	(418,261)	(3,856,900)
2000	\$13,357,526		801,452	283,180	216,632	1,301,263
2001	(\$13,313,806)			(266,276)	(203,701)	(469,977)
2002	(\$95,012,356)				(1,425,185)	(1,425,185)
	Total	(\$1,344,498)	(\$745,943)	(\$529,843)	(\$1,830,515)	(\$4,450,799)

B. How Nicor Can Overcharge Ratepayers by about \$100 Million and Still Be Among the Lowest Cost Providers of Natural Gas in Illinois?

Q. Nicor witness D'Alessandro states that

Nicor was among the lowest cost providers of natural gas in Illinois for the last 5 years—a period that includes the more traditional regulation of gas costs, pursuant to Illinois Commerce Commission (the “Commission”) prudence reviews under the purchased gas adjustment (“PGA”) reconciliation proceedings, as well as Nicor’s operations under the GCPP. (D'Alessandro Direct, pp. 3-4)

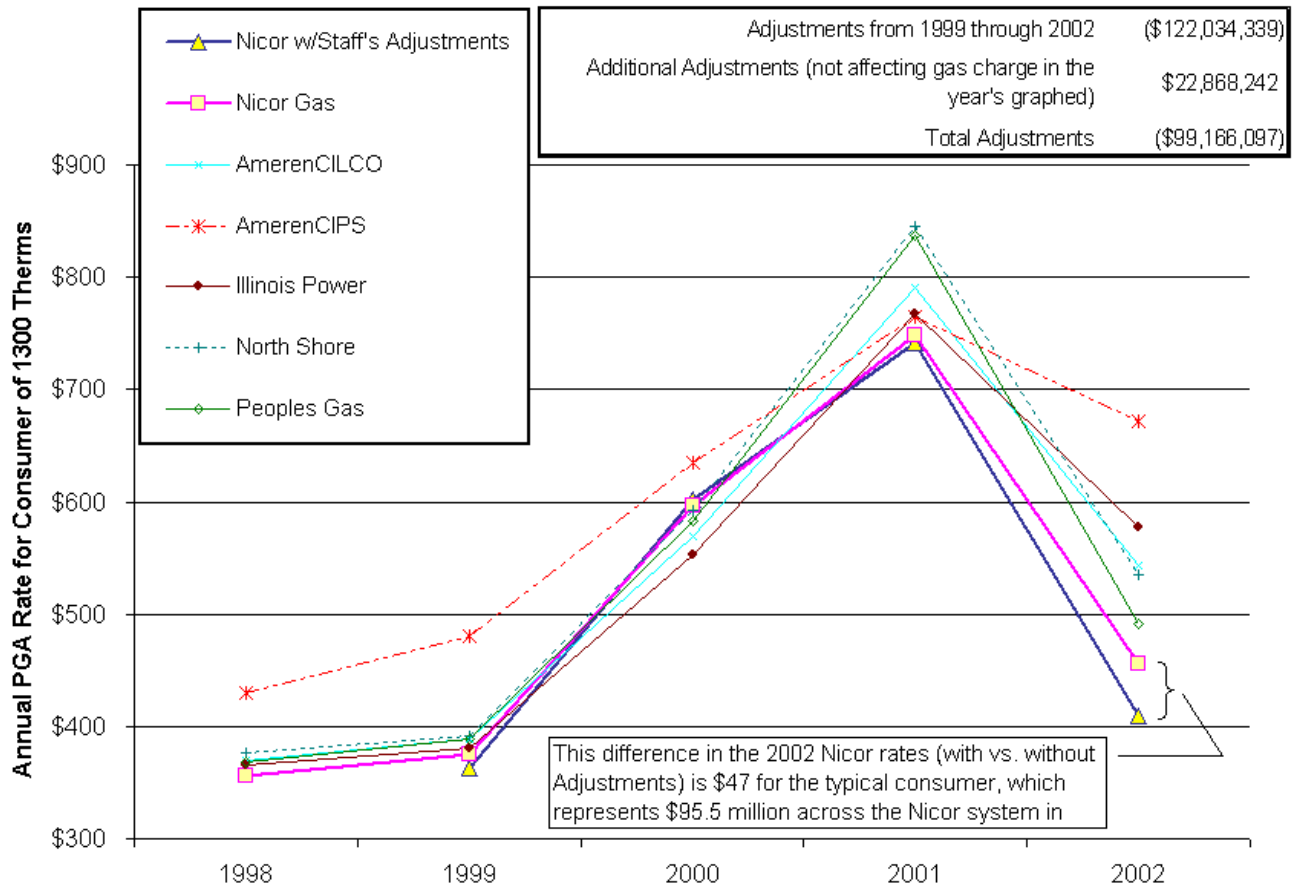
To support this statement, Mr. D'Alessandro points to his Attachment RJD-1, which compares the PGA rates of Nicor with five other Illinois utilities from 1998 through 2002. How is it that Nicor can owe ratepayers about \$100 million (by your computations), but still be among the lowest cost providers of natural gas in Illinois?

A. The seeming paradox is easily resolved. First, when dealing with annual PGA expenditures on the order of magnitude of a billion dollars, inappropriately adding a few million here and there amounts to a relatively small percentage change and is unlikely to affect the Company’s price ranking among other gas companies. For example, the Aquila transaction (bartering a discount on a gas sale for a discount on a non-PGA weather insurance purchase) amounted to inappropriately absorbing about \$6.1 million into the 2001 PGA. That is significant, in my view, but it still amounts to only a quarter of one cent per therm, or less than one-half of one percent of Nicor’s average PGA rate that year.

Second, the problem is not always that Nicor increased costs. In some cases, Nicor’s actions may have reduced gas costs relative to other utilities. The most significant example of this is the LIFO strategy. However, as previously argued (and I

will not repeat those arguments here), the Company should not be permitted to retain a 50% share of those particular “savings.”

Figure 4. Relative Significance of Nicor Adjustments versus PGA Variations Between Utilities



To further clarify, Figure 4 above puts the total adjustments proposed by Staff into perspective. It compares Nicor’s PGA rate from 1998 through 2002 before and after the adjustments to the PGA rates of five other Illinois LDCs.⁵⁹ The choice of utilities and the choice of units of measurement are based on Mr. D’Alessandro’s Attachment RJD-1. As shown in the graph, the adjustments have no impact whatsoever on the relative

⁵⁹ For the line labeled “Nicor w/ Staff’s Adjustments,” proposed cost changes were applied to the year in question, while share-of-the-savings adjustments were applied to the following year (the year in which they are flowed through the PGA).

1714 placement of Nicor's PGA rates among those of the other five utilities included in the
1715 analysis. Both before and after the adjustments are taken into account, Nicor is still
1716 ranked 1st (with the lowest PGA rate) in four of the five years, and is still ranked 5th in
1717 one of the years (year 2000). The final year (2002) is particularly informative, showing
1718 that even a \$95.5 million change in Nicor's total PGA (due to Staff's adjustments) is
1719 dwarfed by the variation between utilities. The \$95.5 million adjustment translates to 4
1720 cents per therm or \$47.46 for the typical consumer, assumed by Mr. D'Alessandro to
1721 consume 1,300 therms per year. The other years depicted in the graph show the proposed
1722 adjustments to be even less significant, when compared to the variation between the
1723 different utilities' PGA rates.

1724 **C. General Comments Concerning Staff's Proposed Adjustments**

1725 **Q. Do you have any general comments pertaining to the approach taken by the Staff in**
1726 **the re-opening phase of this proceeding?**

1727 A. Yes. In Docket 99-0127, the Company strongly protested concerns by Staff that
1728 Nicor might be tempted to misuse storage in an effort to manipulate the computation of
1729 "savings" under the proposed benchmark. The Staff presented an argument that the
1730 storage credit adjustment was vulnerable to such manipulation, whereby the Company
1731 could artificially produce "savings" (and share in half of them) while actually raising gas
1732 prices to consumers. In response, the Company asserted in no uncertain terms that it had
1733 virtually NO control over storage operations. Storage operations were simply a function
1734 of weather, according to the Company. In any event, the Company further argued, it
1735 would never do anything to purposefully raise gas costs to its customers. The
1736 Commission accepted the Company's pledge that storage operations were a passive

reaction to weather and, in any event, storage would not be manipulated solely for the Company's financial gain.

At the time of its decision, I believe that the Commission made a reasonable judgment call. In my own mind, Nicor Gas had a good reputation and there was nothing in the record to suggest that the Company had ever deceived the Commission in the past. Thus, faced with uncertainty over motives, the Commission chose to trust that the Company would not manipulate the PBR benchmark. The record in the current proceeding will make clear that the Company violated that trust. And yet, the Staff's recommendations do not attempt to "punish" or fine the Company for its violation of trust or for anything else. Rather, the Staff's recommendations merely attempt to more properly restate gas costs, the benchmark, and PBR savings over the period in question.

D. Supplemental Assessment of Whether the GCPP Met Its Objectives

Q. According to Nicor witness D'Alessandro, "Nicor is seeking a determination from the Commission that the GCPP met its goals..." (D'Alessandro Direct, p.7) Between the time your pre-reopening testimony was admitted into evidence and now, have you reassessed whether the PBR program has met its original objectives?

A. Yes. In its original order, approving the GCPP, the Commission noted the three "objectives" that had been declared by Nicor Gas:

First, the Program would align the interests of ratepayers and the Company by providing appropriate economic incentives for Nicor Gas to improve its performance in providing customers with the best gas prices available, while recognizing the need for continued reliability and security of supply. Second, the Program would encourage the appropriate use of competitive market opportunities and risk management mechanisms for procurement of gas supply, transportation, and storage services by establishing a reasonable balance between risk and reward. Third, the Program would lower regulatory costs by establishing an objective, market-based standard for evaluating gas supply purchasing, planning,

1765 *and management, while also eliminating after-the-fact prudence*
1766 *reviews.*⁶⁰

1767 In my pre-reopening testimony I noted just a few concerns with the Program,
1768 specifically citing the need to make modifications to the benchmark and the savings
1769 mechanism to better align the interests of ratepayers with Nicor (i.e., objective one).⁶¹ I
1770 found no specific problems concerning objectives two and three.⁶²

1771 I have a somewhat less sanguine view, now. In particular, as discussed above at
1772 length, there were significant problems with the benchmark that I did not recognize prior
1773 to reopening (such as the storage credit adjustment's susceptibility to manipulation and
1774 the failure of the benchmark to account for easily-generated LIFO savings). In addition,
1775 given the amount of work that has gone into this Docket since July 2002, it now seems
1776 very unlikely that the Program ultimately lowered regulatory costs. The ICC Staff alone
1777 has expended considerable time and effort studying documents and trying to get to the
1778 bottom of things. In addition to the State's costs, Nicor has undoubtedly incurred
1779 substantial legal fees and other costs arising from this and other investigations
1780 surrounding the PBR program. Therefore, it is reasonable to conclude that the Program's

⁶⁰ Docket 99-0127, Order, p. 3.

⁶¹ With respect to the first objective, in my original direct testimony in the pre-reopening phase of Docket 02-0067, I opined that

With certain exceptions, which are explained below, the Program has been successful in aligning the interests of ratepayers and the Company by providing economic incentives for Nicor Gas to improve its performance in providing customers with lower gas prices. With changes to the Program, a better alignment of interests can be achieved and rates can be reduced further in the future. It is not clear that the Program has had any effect on reliability and security of supply. (p. 5)

⁶² With respect to objectives two and three, in my original direct testimony in the pre-reopening phase of Docket 02-0067, I opined that

The Program appears to have encouraged the use of competitive market opportunities. It is doubtful the Program encouraged the use of risk management mechanisms for protecting customers against swings in prices or temperatures. I do not know if the Program lowered the Company's regulatory costs, but I see no reason why they would increase those costs. (p. 6)

1781 third objective--to “lower regulatory costs by establishing an objective, market-based
1782 standard for evaluating gas supply purchasing, planning, and management, while also
1783 eliminating after-the-fact prudence reviews”--has not been satisfied.

1784 **Q. Does this conclude your testimony?**

1785 A. Yes.